Prepared Remarks on the Closing the Corporate Stabilization Fund and Setting the Share Insurance Fund's Normal Operating Level
July 20, 2017

The following are the prepared remarks of staff from NCUA's Offices of Examination and Insurance, General Counsel, the Chief Financial Officer and the Chief Economist during their presentation on closing the Corporate Stabilization Fund and merging it into the Share Insurance Fund during the July 2017 open NCUA Board meeting. A video recording of the open Board meeting will be available online here in about three weeks.

These remarks accompany the staff's slide presentation, which is available, along with more information from the meeting, on the Board meeting agenda page. More details about the agency's plan to close the Stabilization Fund in 2017 are available on the Stabilization Fund Closure web page.

The NCUA is seeking public comments on the plan. You may submit comments online here. Comments must be received no later than September 5. The agency will host an informational webinar on the Stabilization Fund closure plan on August 9.

Slide 1: Larry Fazio, Director of Examination and Insurance

Good morning, Chairman McWatters and Board Member Metsger. We are here today to propose closing the Temporary Corporate Credit Union Stabilization Fund in 2017 and seek public comment on this course of action. As part of closing the Stabilization Fund, we are also proposing increasing, at least for the time being, the normal operating level of the Share Insurance Fund.

Our goal today is to provide stakeholders with some background on the overall corporate system resolution program, address all of the key considerations related to the Stabilization Fund's closure, and explain how we arrived at the recommended increase to the normal operating level.

It is important to note the information and projections we are providing today represent a point-in-time estimate generated as of the end of the first quarter of 2017. This information is preliminary, unaudited, and subject to change. We include a variety of projections and actual results may vary.

Slide 2: Fazio

Let's start with the bottom line. The Stabilization Fund has served its purpose. We're now at the point where we can prudently close the Stabilization Fund and have the Share Insurance Fund handle the remaining obligations of the corporate system resolution program. As you'll note on the slide, all outstanding Treasury borrowings have been repaid as of October 2016. The outstanding obligations related to the legacy assets and NCUA Guaranteed Notes are now smaller than the size of the Share Insurance Fund. Over 90 percent of the projected legacy asset defaults have been realized. The Stabilization Fund's net position has gone from a negative $7.5 to a positive $1.6 billion as of March, and we received additional legal recoveries in May that are not yet reflected in the net position.

Having said that, there are remaining obligations of the corporate system resolution program. While manageable, these obligations could create some significant volatility to the Share

Insurance Fund's equity ratio, necessitating that some additional equity be held in the Share Insurance Fund.

Slide 3: Fazio

But before we go into all the details about these proposed actions, I think it would be useful to provide a little bit of background context for stakeholders.

As you know, during the economic crisis, five corporate credit unions, including the four largest, failed due to over-concentration in primarily private label mortgage backed securities, which we often refer to as legacy assets. As of 2009, the total unpaid principal balance for the legacy assets was $52.7 billion, but their market value was less than $22 billion. Thus, the resulting losses to natural person credit unions would have been catastrophic. The agency's Corporate System Resolution Program prevented that scenario. A key element of the resolution program was the creation of the Stabilization Fund, which allowed the system to absorb the losses over time and prevent impairment of the 1 percent deposit in the Share Insurance Fund.

A few elements of the resolution phase remain—specifically the Stabilization Fund, the NCUA Guaranteed Note Program and the five Asset Management Estates, one for each of the failed corporate credit unions.

Slide 4: Fazio

In particular, the NGN program began with the first deal issued in October 2010 and the last deal issued in June 2011 for a total of 13 deals. When the final NGNs mature in 2021, we will move into the final phase of the resolution program, consisting of monetization of remaining estate assets, payout of creditors, and closure of the estates.

Slide 5: Fazio

As I noted previously, all Stabilization Fund borrowings have been repaid as of October 24, 2016. The initial Stabilization Fund borrowing occurred on June 25, 2009, which per the Act, started the clock on the temporary seven-year life of the Stabilization Fund. In September 2010, the Treasury Secretary approved extending the closing date of the Stabilization Fund to June 2021 to match the life of the NGN program.

The borrowings, combined with $4.8 billion in credit union assessments, were necessary to fund the cash and contingent liquidity needs of the Stabilization Fund. The Treasury borrowings have been repaid primarily through legal recoveries, assessments, NGN guaranty fees and distributions from the Share Insurance Fund.

Slide 6: Fazio

On this slide, you can see a list of the 13 NGNs that were issued, their issuance dates, face amounts, and total proceeds raised of $28 billion. The NGNs all have hard final maturities of 10 years or less. This was done to achieve better execution and pricing for the deal offerings and to

ensure the NCUA guaranty obligation associated with the NGNs did not extend beyond the life of the Stabilization Fund.

Slide 7: Fazio

This slide shows the NGNs that have matured to date and the projected maturity dates of the outstanding NGNs. Because the legacy assets in certain NGN series performed better than expected, and NCUA designed all but one of the NGNs to amortize in concert with performance of the underlying legacy assets, four NGN series have paid off before their hard final maturities. None of these four NGN series required NCUA to make guaranty payments.

There are 14 NGN series still outstanding. Two additional series are projected to mature in Q4 2017, and the remainder do not mature until 2020 and 2021.

Slide 8: Fazio

We are projecting a total of $3.3 billion in guaranty payments on the NGNs. Upon closure of the Stabilization Fund, the projected guaranty payments related to these would become obligations of the Share Insurance Fund.

These guaranty payments are already included in the net position of the Stabilization Fund. Also, we project the Share Insurance Fund to have sufficient liquidity to make the payments and maintain an available assets ratio of 1 percent, which is a requirement of the Act.

Slide 9: Fazio

This slide provides some high-level statistics on the current status of the NGNs and the associated legacy assets. The outstanding balance to NGN investors is now lower than the size of the Share Insurance Fund and the market value of the underlying legacy assets.

Also as I noted previously, about 90 percent of projected legacy asset defaults have already been realized.

Slide 10: Fazio

This slide starts with the projected lifetime legacy asset defaults that we ended with on the previous slide. After you account for some features of the resolution program that offset some of the defaults, like excess spread we earned between the rates of the NGNs and underlying legacy assets, you get the total gross resolution costs of $8.7 to $9.9 billion. Then when you deduct the legal recoveries, you get net resolution costs of $5.5 to $6.7 billion. This net resolution cost to the credit union system comes in two forms: those borne by all insured credit unions through Stabilization Fund assessments and those borne by holders of depleted corporate capital.

Given that credit unions have paid $4.8 billion of assessments to date, this means the projected return of these assessments is $2.6 to $3.0 billion. We currently project a recovery to depleted capital holders of $1.1 to $1.9 billion. The recovery for depleted capital holders operates on a

different basis than any return of assessments. Depleted capital holders are not projected to receive any recoveries until at least 2021.

Please keep in mind these are all-in projections and certain items have different recognition standards for financial statement presentation purposes.

Slide 11: Fazio

This slide shows the Stabilization Fund's net position over its history. As you can see, it is now positive, which is one of the requirements for closing the Stabilization Fund. However, we should note that this positive net position is not all cash; in fact, it is predominately made up of a receivable that is based on projections.

With that, I will turn it over to Kevin to discuss legal matters associated with the proposed closure of the Stabilization Fund and distributions from the Share Insurance Fund.

Slide 12: Kevin Tuininga, Senior Staff Attorney, Office of General Counsel

In developing the proposal to close the Stabilization Fund in 2017, we fully reviewed the Board's authority with respect to the Fund. The Stabilization Fund has a mandatory closing date, which NCUA extended to June 2021 with the concurrence of the U.S. Treasury. However, the statute also permits the Board to close the Stabilization Fund prior to its mandatory closing date, subject to resolution of all Stabilization Fund deficits. This condition has been met.

We also reviewed whether the Board could make a general distribution to insured credit unions from the Stabilization Fund. We concluded that the act does not permit such a distribution. Other than as expressly permitted for insurance purposes, special assistance, or expenses in connection with corporate credit unions, the Board can make a Stabilization Fund distribution to only one recipient, the Share Insurance Fund.

Once the Stabilization Fund's assets are distributed to the Share Insurance Fund, a distribution to insured credit unions will be made if three conditions are met as of the end of a calendar year:

- All loans to the Share Insurance Fund from the federal government are repaid;
- The Share Insurance Fund's equity ratio exceeds the normal operating level; and
- The Share Insurance Fund's available assets ratio exceeds 1.0 percent.

We would also note that a Share Insurance Fund distribution is separate from the payment of capital holder claims against the corporate credit union estates. Under NCUA regulations, payments to capital holders from the estates will not occur until the liquidating agent makes full payment, or provision for full payment, of all more senior claims. This is unlikely to be possible until 2021 for any of the estates.

With that, I will turn it over to Rendell to discuss NCUA's proposed financial statement and audit approach.

Slide 13: Rendell Jones, Chief Financial Officer

My portion of this presentation will focus on the financial reporting aspects of closing the Stabilization Fund.

We evaluated several scenarios of closing the Stabilization Fund and transferring all assets and liabilities into the Share Insurance Fund, with the goal of being able to close the fund by the end of the calendar year, such that the Share Insurance Fund can make a distribution to Federally Insured Credit Unions in 2018.

After review of several potential closure dates, staff recommends that the Stabilization Fund is closed with all assets and liabilities transferred into the Share Insurance Fund on October 1, 2017 using closing balances as of September 30, 2017.

As a reminder, at each quarter-end, we conduct a valuation of the legacy assets supporting the NGN Program and have certain balances audited as of September 30 as part of the government-wide audit. Accordingly, conducting the closing at the end of the third quarter provides for a complete accounting of the Stabilization Fund.

While we have spent much effort addressing contingencies related to closing the Stabilization Fund, closing the Fund after the third quarter provides time to recover from unforeseen contingencies. That is, if we decide to close the fund as of December 31, 2017, and a logistical item did not proceed as planned, federally insured credit unions would need to wait another year before a distribution could be made.

I also recommend a full scope financial statement audit of the Stabilization Fund's closing balances, which will be as of September 30, 2017. While not required, this would ensure that all transactions of the Stabilization Fund as it existed would be covered by an audit. This would also provide assurance over the accuracy, completeness, and validity of the balances as of and for the period ending September 30, 2017. Having the closing financials audited provides transparency on the values transferred into the Share Insurance Fund.

As is the case annually, at the December 31 reporting period-end, an audit will be conducted on the Share Insurance Fund, which would then include the asset and liability balances that were in the Stabilization Fund.

At the December 31 reporting period end, stakeholders will be looking at the Share Insurance Fund's equity ratio, which is one of the determinants of whether and how much of a distribution will be made.

Thus, the December 31 audit will allow NCUA to be transparent to its stakeholders, as the Share Insurance Fund will show its entire 12 months of operations, plus balances transferred from the

Stabilization Fund and all legacy Stabilization Fund operations for the fourth quarter, including the Corporate Asset Management Estates and NGN-related activities.

Overall, these two audits will help fulfill transparency to our stakeholders. We considered and rejected other options, such as auditing only the NGN-related balances or all material balances. However, with respect to NCUA's responsibility to all of its stakeholders, including member capital holders, the benefits of assurance provided by a full-scope audit outweighed the incremental costs.

One issue that we addressed was the presentation of 2016 Stabilization Fund activities within the Share Insurance Fund's audited financial statements. Under commercial accounting standards, often referred to as U.S. GAAP, when one entity is combined into another, the prior year financial statements are restated as if it was one entity prior to the combination date.

Under federal government accounting standards, prior year financial statements do not have to be restated. Under GAAP for the federal government, in certain cases, restatement can be misleading to the public and the financial statements should show the transactions when they were effective.[1]

Simply put, restatement of 2016 financial statements solely for the purposes of comparability would be inappropriate because the combined functions of the Share Insurance Fund and Stabilization Fund did not exist during the prior year. That is, the financials show the effect on the Share Insurance Fund from and after the date of transfer of October 1, 2017.

Now we turn to the recovery of the U.S. Central $1 billion capital note.

Another issue was whether a recovery could be recognized on the U.S. Central $1 billon capital note.

The Stabilization Fund's claims on the estates include the billion dollar capital note that the Share Insurance Fund provided to U.S. Central in January 2009. The Board subsequently transferred this note to the Stabilization Fund and it was written down to zero ($0) through an impairment. Under GAAP, an Other-Than-Temporary-Impairment was recognized in 2009. Thus, under accounting rules, the Capital Note will not be recovered until cash is received. Based on current estimates, cash of approximately $500 million to $800 million is expected to be available to repay part of the capital note by December 31.

[1] This treatment is allowed under federal accounting standards, Technical Bulletin 2003-1, which was in response to merging entities in the Department of Homeland Security.

Slide 14: Jones

The Share Insurance Fund's financial statement presentation will be slightly different after the closing. This slide shows a pro forma balance sheet, as if the Stabilization Fund was closed with all assets and liabilities transferred into the Share Insurance Fund as of March 31, 2017.

While we have not worked out the exact line-item disclosures, our goal is to continue to provide transparency, especially to balances related to the asset management estates and their stakeholders, such as member capital holders.[2]

The takeaways from these slides are:

- The transfer-in from the Stabilization Fund will provide a significant increase in cash and investments;
- A significantly larger, but separate Receivable from Corporate Asset Management Estates; and
- The Net Position will increase significantly; all leading to an expected increase in the equity ratio.

Again, this is a pro forma, so actual balances will vary. It is only meant to demonstrate what the results may look like after the close of the Stabilization Fund and transfer of assets and liabilities into the Share Insurance Fund.

With that, I will turn it over to Larry to discuss the equity ratio and normal operating level of the Share Insurance Fund.

Slide 15: Fazio

The pro-forma balance sheet that Rendell just walked through looks at what the net position of the Share Insurance Fund would be if the Stabilization Fund had been closed on March 31, 2017. Starting with that number, we then project activity expected to occur prior to the end of the year, to estimate the Share Insurance Fund's net position as of December 31, 2017. There is a variety of factors that went into these assumptions, and they do not include any unanticipated activity, such as extraordinary insurance losses or abnormally high insured share growth.

The top line of this table shows the pro-forma March 31, 2017, post-closure net position, from the prior slide. In the second quarter, NCUA received additional legal recoveries, of which approximately $310 million is included in the projected net position. Then, we estimate that somewhere between $500 million and $800 million of the $1 billion U.S. Central capital note will be repaid by the end of the year, based on how much cash is available for re-payment. Then,

[2] Accordingly, this statement is preliminary and unaudited; the presentation of the audited Share Insurance Fund's 2017 financials will be in compliance with federal accounting standards as well as meet our goal on transparency.

we also include a projection of the Share Insurance Fund's net income for the remainder of the year. Lastly, in October, credit unions with assets over $50 million will true-up their 1 percent capitalization deposit, so this line represents the projected increase to the contributed capital deposits. All of this results in an estimated net position of $15.7 to $16 billion at the end of 2017.

Slide 16: Fazio

Using the projected year-end net position of the Share Insurance Fund, we can now calculate the estimated equity ratio. This slide shows the statutory definition of the equity ratio and the formula. In short, the numerator is the net position less any unrealized gains or losses. The numerator is divided by total insured shares, the denominator, to arrive at the equity ratio. Thus, we also have to estimate insured shares for December 31. This results in a projected equity ratio of 1.45 percent to 1.47 percent at calendar yearend. I would note that we do not project the gain (loss) on investments and this figure along with all of the estimates herein could vary materially from actual results on December 31, 2017.

Slide 17: Fazio

The calendar yearend equity ratio is important because it is part of the statutory basis for determining whether a distribution is made to insured credit unions. Kevin previously covered the three criteria that must be met for a Share insurance Fund distribution. As we've already noted, all loans from the government have been repaid. Also, the available assets ratio, which was 1.21 percent as of March 31, 2017, is projected to remain well above 1 percent, with a surplus of over $4 billion in liquid funds. Thus, the distribution will come down to the extent to which the equity ratio exceeds the normal operating level at calendar year end.

Slide 18: Fazio

So, the normal operating level represents the point at which excess equity is returned to credit unions. Historically, the Board has set the normal operating level as the target equity ratio for the fund. It was last set at 1.30 percent in 2007. The methodology used to set the normal operating level pre-dates the 2007 to 2009 economic crisis and has not been updated since.

Slide 19: Fazio

This slide depicts the statutory parameters for how the Board must manage the fund, including requirements for the normal operating level. A few important things to note:

- Any impact that drops the equity ratio below 1 percent would result in a direct expense to credit unions through impairment of the 1 percent deposit, which they show as an asset on their financial statements. This actually happened in 2008–2009 before Congress created the Stabilization Fund.

- Congress set a floor for the normal operating level in the Federal Credit Union Act at 1.20 percent. If the equity ratio falls below 1.20 percent (or is projected to within 6

months), the Act mandates the Board must assess a premium to restore the fund to at least 1.20 percent or adopt a fund restoration plan.

- Congress set a ceiling for the normal operating level of 1.50 percent.

- Also, the NCUA Board may not assess a premium if the equity ratio exceeds 1.30 percent. So, even though the equity ratio could be allowed to go as high as 1.50 percent, it can only get above 1.30 percent through earnings, not premiums.

Slide 20: Fazio

With these constraints in mind, we re-evaluated what the normal operating level should be if the Stabilization Fund is closed and its obligations become part of the Share Insurance Fund. We need to ensure the Share Insurance Fund holds enough equity to cover the risks posed by these new obligations. To determine what level of equity the Share Insurance Fund needs to handle its customary exposures along with the remaining corporate resolution program obligations, we modeled the impact on the equity ratio under two different economic scenarios—a moderate and a severe recession. Ralph will now talk about the economic scenarios used in the modeling.

Slide 21: Ralph Monaco, Chief Economist

To begin the modeling of the potential changes to the equity ratio under changing economic conditions, we used the economic scenarios developed by the Federal Reserve as part of their work on the Comprehensive Capital Analysis and Review. As the slide shows, the Federal Reserve publishes two relevant scenarios for our purposes.

The Adverse economic scenario is characterized as a moderate recession, coupled with declining asset prices and low interest rates. As the slide shows, the unemployment rate in the Adverse scenario averages more than 7 percent in 2018 and 2019, the years where the rate is highest. For comparison, the current unemployment rate is 4.4 percent. Short-term interest rates fall to about 10 basis points, about 90 basis points below where they are right now. Long-term rates edge slowly higher; the rate on the 10-year Treasury note remains below 3 percent throughout the scenario. Home prices fall 17 percent below the Fed's baseline assumption.

The recession in the Federal Reserve's Severely Adverse scenario is much worse than in the Adverse. The unemployment rate averages more than 9.5 percent in 2018–2019 and is just under 10 percent for some of the quarters in those years. Short-term and long-term interest rates fall and remain low; the rate on the 10-year Treasury note is below 2 percent for the entire scenario. House prices fall to 30 percent below the Fed's baseline assumption in 2019; which is roughly the same distance they fell around the financial crisis and Great Recession. In general, the Severely Adverse scenario has many characteristics that are similar to the Great Recession.

The hypothetical economic scenarios developed by the Federal Reserve extend for 13 quarters and the banks and credit unions that use these scenarios are required to examine their capital positions after nine quarters. While this horizon may be appropriate for examining depository institution capital positions, the 9- and 13-quarter horizons do not account for the time it takes

for corresponding problem institutions to be reflected in the Share Insurance Fund's reserve needs. Thus, to have a more complete view of the effects of the changing economy on the insurance fund, our analysis has to extend beyond the 9- and 13-quarter horizons.

In that context, it's useful to remember that while the recession may have ended, the economy, though recovering, may remain very weak. A struggling economy poses risks to credit unions, similar to the risks posed during the actual downturn. A thorough analysis of the Share Insurance Fund's position needs to account for the period of continued economic weakness to have a more realistic picture of the recession's overall effects.

Technically, recessions tend to be short. However, their effects are much longer-lasting. The National Bureau of Economic Research—the not-for-profit research organization that establishes the beginning and end of U. S. business cycles—has calculated that we've averaged 69 months from the peak of one business cycle to the next. That is nearly six years.

With that as context, we extended our analysis to five full future years, in addition to the final three quarters of 2017. This provides for some allowance for the time it will take for changes in capital positions of credit unions to impact the position of the Share Insurance Fund. Federal Reserve scenarios were extended to 2021 and shifted forward by one quarter using data supplied by Macroeconomic Advisers, LLC. NCUA extended key variables for 2022 by keeping 2021 growth rates, interest rates, and unemployment rates constant at their 2021 levels for each scenario.

Using the Adverse and Severely Adverse scenarios as a backdrop, we modeled the potential effects on the Share Insurance Fund's equity ratio. We'll first look at the asset management estate valuations and then look at the more traditional channels of economic impacts on the equity ratio. With that, I will turn it over to Brian.

Slide 22: Brian Heitman, NGN Financial Analyst, Division of NGN Support, Office of Examination and Insurance

Changes in cash flow projections on the legacy assets will impact the Share Insurance Fund equity ratio, assuming the Stabilization Fund is closed. The cash flow changes do not translate dollar-for-dollar to the value of NCUA's claims on the estates and, ultimately, the equity ratio. Legacy asset principal and interest cash flows received by the NGN trusts run through the applicable NGN waterfalls and are then applied to the payout priority categories for each of the asset management estates. The factors listed on this slide affect, to varying degrees, the equity ratio from projected NGN and legacy asset cash flow changes.

Slide 23: Heitman

To determine the impact of the stress scenarios on the legacy assets, NCUA had BlackRock model the cash flows under the macroeconomic Adverse and Severely Adverse scenarios developed by the Federal Reserve. BlackRock also derived and applied credit spreads for cash flow discounting purposes related to these scenarios.

The discounted legacy asset cash flows decrease from the base scenario by $2.0 and $3.0 billion for the Adverse and Severely Adverse scenarios, respectively.

Slide 24: Heitman

Legacy asset cash flows are then run through the applicable NGN waterfalls to project guaranty fees paid to NCUA, guaranty payments made by NCUA to NGN investors for principal and interest shortfalls, guaranty reimbursements made to NCUA for any guaranty payments made, and any residual cash flows left after all of these payments have been made. Credit spread levels are also applied to the NGN cash flows for discounting purposes.

The discounted NGN net cash flow projections decrease from the base scenario by $1.9 billion and $2.9 billion for the Adverse and Severely Adverse scenarios, respectively.

Slide 25: Heitman

This slide provides the bottom line impact on the fund's net receivables from the estates based on the estate payout priorities—a reduction of $400 million in the Adverse scenario and $1.1 billion in the Severely Adverse scenario—which equates to approximately 4 to 11 basis points on the equity ratio.

Slide 26: Heitman

We will now go through a series of slides that show how the base case NCUA net receivable from the estates is calculated. The appendix to this slide deck includes the calculations for the Adverse and Severely Adverse scenarios for stakeholders to reference.

This slide shows the preliminary and unaudited schedule of fiduciary net assets and liabilities broken out by the five corporate asset management estates. The total amount the estates owe the Stabilization Fund, not including the $1 billion capital note for U.S. Central, is approximately $4.0 billion, shown on the "Due to Stabilization Fund" line and highlighted in red. Keep in mind, the estates do not cross-collateralize each other. Therefore, the math must be done separately for each estate.

Slide 27: Heitman

This slide and the six that follow walk through all of the details of the related calculations. Please keep in mind that the main point is to show each estate's balances owed, the projected cash flows for each estate, and the amount of those projected cash flows that would end up as a receivable to NCUA.

Columns A through D on this slide show the balances each estate currently owes to NCUA, plus the NGN investor balance NCUA guarantees. As shown on the previous slide, Column B shows the approximately $4 billion the estates owe the Stabilization Fund, not including the $1 billion capital note for U.S. Central which is in Column D. Columns E through G represent projected

cash outflows from each estate in the future. These primarily consist of guaranty payments for the NGNs shown in column E.

Slide 28: Heitman

This slide shows the balances owed by estate to each class of creditor after projected cash outflows from the prior slide.

After the NGN investor balances are repaid, the remaining columns follow the payout priorities, as outlined in section 709.5 of NCUA's Rules and Regulations. Columns I, K, and L show the amount the estates are projected to owe NCUA after application of total projected guaranty payments and other outflows in column G of the previous slide. Finally, in the least senior positions, columns M and N show the depleted capital balances.

Please note that member capital and paid-in capital shown here, plus retained earnings lost at liquidation for the failed corporates, equals the $5.6 billion depleted corporate capital number shown on slide 10.

Slide 29: Heitman

This slide shows the cash sources and uses of the NGN trusts. Not all of these cash flows directly impact NCUA or the asset management estates. For example, cash goes directly to the NGN investors in the most senior position in column R. Also, cash goes directly to NCUA in the form of a guaranty fee in column S. Neither of these cash flows go through the payout priorities of the estates.

After that, the remaining collateral cash flows go through the payout priorities of the estates in the form of guaranty reimbursements shown in column T and residuals shown in column U. Notice that the total cash used in column U match the total cash sources in column Q.

Slide 30: Heitman

This slide shows the projected inflows for each estate. Column W shows the sum of the projected reimbursements and residuals from the previous slide. Column X shows the projected non-NGN inflows from loans and other fiduciary assets shown on slide 26. Column Y shows the impact to each estate from the two legal settlements received after the March 31, 2017 measurement date. Column Z shows the projected capital recovery from U.S. Central. To further clarify column Z, we must note that if depleted member capital is repaid to U.S. Central, portions of it will be distributed to the other four estates that had capital at U.S. Central.

Slide 31: Heitman

This slide shows the details of how the projected inflows for each estate impact the remaining balances at each level of the payout priorities. Projected inflows in column AA are applied to the claims listed in order from left to right, starting with categories B1 and B4 in column AC and

ending with category B9 in column AH. If any projected inflows remain after that they become a member dividend as shown in column AK.

Using U.S. Central as an example, you can see that each category through B6.5 in column AF is projected to be completely repaid, as evidenced by the zero end balance in each of those columns. Then category B7 receives a partial repayment in column AG, leaving nothing to repay any amounts to the right of category B7. Also, you'll notice that the total projected inflows in column AA match the total repayments shown in the middle row of the total column after column H for each estate.

Slide 32: Heitman

This slide simply shows the unpaid balances from the prior slide—in other words, what is projected to not be repaid.

Slide 33: Heitman

This slide brings all of this together to estimate NCUA's net recovery, as shown in column AM. Columns AN through AQ show the adjustments that have to be made for items not currently recognizable in the Stabilization Fund financial statements. Column AR then shows NCUA's corresponding net receivable from the estates as reflected on the fund's financial statements – and thus what would affect the equity ratio.

Slide 34: Heitman

Now that we've explained the quantitative details involved, this slide reiterates the bottom line summary shown previously.

With that, I will turn it over to Ralph to discuss the performance of the Share Insurance Fund in stressed macroeconomic environments and the related impact to the equity ratio.

Slide 35: Monaco

Thanks, Brian. Brian just covered the impact on the equity ratio if the Stabilization Fund is closed, and the Share Insurance Fund were to absorb its assets and liabilities. I'm now going to talk about the performance of the Share Insurance Fund, without including remaining corporate system resolution program exposures, under the same economic scenarios.

The economic stress analysis starts by looking at historical relationships to link the three main drivers of the Share Insurance Fund's equity ratio (insurance losses, insured share growth and yield on investments) to the economic variables contained in the Federal Reserve scenarios. Then we use these projections of the drivers to simulate how the Share Insurance Fund would perform.

To be specific, equations were developed to link economic conditions to insured share growth and insurance losses. The relationships in these equations are based on historical data and are

straightforward. For example, historically, higher unemployment rates and falling home prices are associated with a rising proportion of deposits in troubled credit unions. To make projections of insurance losses, we used this relationship and applied a fixed loss rate to the deposit share of troubled credit unions. So, in a nutshell, the modeling work says that a deteriorating economy increases the share of overall credit union deposits in troubled institutions, which in turn, typically means more losses for the fund.

With respect to insured share growth, historical data suggest that insured share growth generally increases initially when the economy turns down and the unemployment rate goes up—probably because members are seeking the safety of federal insurance for their funds. In addition, it appears that share growth is higher when consumer income is growing faster, but that increases in interest rates generally slow insured share growth.

To project Share Insurance Fund performance, we took the insured share growth, insurance loss, and yield projections derived from the Federal Reserve scenarios and used them as inputs in the model. As noted above, to make a more useful set of projections, it was necessary to extend the Federal Reserve's 13-quarter forecast horizon to incorporate five full forecast years, which extends to 2022.

Slide 36: Monaco

This slide shows the projections of three primary drivers for each year. As you can see, these projections are sensibly related to scenarios outlined on slide 21. In both the Adverse and Severely Adverse scenarios, share growth increases during the first few years and then starts to decline. Similarly, during the economic stresses, insurance losses increase throughout the recession, and even though they taper off in the last few years, they remain higher than going into the recession. Losses are much higher in the Severely Adverse scenario than in the Adverse scenario.

Lastly, the yield on the investment portfolio drops relative to the baseline and is much lower in the Severely Adverse scenario than the Adverse scenario. The very low yields mean that the fund will not be able to generate enough revenue to keep the equity ratio from falling. We have held the growth in the operating budget to 4.1 percent for all projection years, although historically the budget has risen faster during a recession to deal with the rising number of problem institutions.

Slide 37: Monaco

This slide shows the model results under both the Adverse and Severely Adverse scenario. We started with 1.26 percent, the fully-contributed equity ratio as of March 31, then projected the equity ratio through 2022. As you can see, from the end of 2017 to the end of 2022, the equity ratio is expected to fall 13 basis points in an Adverse stress scenario and 21 basis points in a Severely Adverse stress scenario. These are very similar to the results that we presented at the November 2016 Board briefing concerning the Share Insurance Fund, using the Federal Reserve scenarios developed for 2016.

A key feature of both scenarios is that, by the end of 2022, the equity ratio is below 1.20 percent. In other words, in either a moderate or a severe recession, it would be necessary to either develop a fund restoration plan or impose a premium sufficient to restore the equity ratio to at least 1.20 percent. With that, I will turn it over to Larry to discuss the objectives for setting the normal operating level.

Slide 38: Fazio

Thank you, Ralph. In its role as the steward of the Share Insurance Fund, NCUA must consider its obligation to protect insured member deposits, the responsibility that comes with being backed by the full faith and credit of the United States, and how management of the Share Insurance Fund impacts the credit union community. These are the over-arching considerations when setting the normal operating level.

These considerations are reflected in the objectives listed on this slide. To achieve these objectives, we believe NCUA should ensure the fund can at least withstand a moderate recession without the equity ratio falling below 1.20 percent. As we noted previously, 1.20 percent is the statutory minimum before the Board must either assess a premium or develop a restoration plan.

Although Congress provided NCUA the ability to develop a fund restoration plan in lieu of mandatory premiums for extraordinary circumstances, the fund should be able to manage a reasonable range of expected and unexpected declines in the equity ratio. Relying on fund restoration plans as a part of normal fund management could erode public confidence in federal share insurance and would not necessarily eliminate the need for credit unions to pay premiums when they could least afford it. NCUA should increase the equity of the fund during times of economic prosperity and allow it to decrease so as not to assess premiums during economic downturns.

Managing the fund to withstand a moderate recession covers a relatively broad range of outcomes. However, there are a number of economic scenarios that could have a greater impact on the fund, but do not rise to the level of a severe global recession.

Slide 39: Fazio

Based on the goal of keeping the fund's equity ratio from falling below 1.20 percent over the five forecast years, the starting equity ratio would need to be 1.33 percent to withstand a moderate recession represented by the Adverse scenario. For the Severely Adverse scenario, the starting equity ratio would need to be much higher at 1.41 percent.

Slide 40: Fazio

It is important to keep in mind that these are projections. Actual results could be better or worse depending on many factors, such as those listed on this slide. Also worthy of note, the equity ratio is expected to continue to decline given the low-yield environment and strong insured share growth, even under no economic stress.

Slide 41: Fazio

This slide shows the expected continued decline in the equity ratio for the base and base-plus projections, with the base-plus using slightly more optimistic assumptions than the base case. So, when setting the normal operating level to account for the increased exposure after closing the Stabilization Fund, we also have to consider any expected decline in the equity ratio before we can start to shed exposure to the remaining legacy assets when the remaining NGNs mature in 2020 and 2021. Under the base-plus case, the equity ratio is projected to decline by at least two basis points between the end of 2017 and the end of 2019. To ensure that we have sufficient equity until 2020, we have to account for this projected 2 basis point decline now, because the Board does not have the authority to charge a premium if the equity ratio is above 1.30 percent.

Slide 42: Fazio

To this point, we've explained the two main exposures to the equity ratio of the Share Insurance Fund if we close the Stabilization Fund and the projected decline in the equity ratio through 2019.

As summarized on this slide, in a moderate recession, the equity ratio would decline by 13 basis points from its customary exposures and another 4 basis points from a reduction in the value of the claims on the corporate estates. In addition, the equity ratio of the fund is expected to decline by 2 basis points even with no economic stress. Given the proposed goal of withstanding a moderate recession, when we consider these three things together, the recommended normal operating level is 1.39 percent.

Slide 43: Fazio

With a proposed normal operating level of 1.39 percent and a projected calendar year-end equity ratio of 1.45 percent to 1.47 percent, the projected Share Insurance Fund distribution in 2018 would be $600 to $800 million.

Please keep in mind, we had to make various assumptions for these projections and actual results may vary. Distributions are normally made in the second quarter of the following year—in this case 2018. How that distribution will be paid out to credit unions is covered in section 741.4 of NCUA's Rules and Regulations. The next item on today's Board meeting agenda is a notice of proposed rulemaking on the distribution process.

Slide 44: Fazio

As we discussed during the beginning of the presentation, we projected a return of $2.6 billion to $3.0 billion of the $4.8 billion in assessments paid to date. Let's go to the next slide to reconcile this to the estimated distribution.

Slide 45: Fazio

Let's start at the top of the slide. You can see the projected $600 million to $800 million distribution to be paid in 2018. Then we add in the additional $200 million recovery on the U.S. Central capital note that is projected to be recognized in the future. Then we add the $400 million of equity to account for the potential decline in the claims against the corporate estates. If there is no economic downturn, these funds may be available for distribution in the future. Then we add in some differences between the projections and what can currently be recognized in the financial statements, like interest and guarantee fees we will collect in the future. That results in approximately $1.4 million to $1.7 million in total potential distributions to credit unions.

The next line shows the approximately $800 million in equity necessary to restore the Share Insurance Fund's equity ratio to the 1.33 percent previously discussed. Below that, this line item reflects the 2 basis points or $200 million for the natural decline in the equity ratio over the next two years, assuming no economic stress. Lastly, once the $200 million to $300 million in discounting differences are included, the total projected return of assessments equals $2.6 billion to $3 billion.

Slide 46: Fazio

Once again, I just need to re-iterate that these are all projections. Any distribution will be based on actual results at calendar yearend.

Slide 47: Fazio

We are proposing the Board approve the attached notice and request for comment, to be published in the *Federal Register* for review and public comment. We are particularly interested in comments relating to whether NCUA should:

- Close the Stabilization Fund in 2017 or at some future date but no later than 2021;
- Set the normal operating level based on the Share Insurance Fund's ability to withstand a moderate recession, or if it should be able to withstand a severe recession; and
- Base the approach to setting the normal operating level on preventing the equity ratio from declining below 1.20 percent or if it should be some higher minimum level.

Information on how to submit comments will be available in the *Federal Register* notice and on our website. In fact, we have created a new page on our website that provides background and support for today's proposed changes.

NCUA will also hold a webinar on August 9 to discuss the proposal and the request for comment, and answer questions from stakeholders. While the comment period is open until September 5, the sooner we receive comments, the sooner we can begin to develop final recommendations for the Board to consider prior to the end of September when we would propose to close the Stabilization Fund.

Though we will not be covering them today, the appendix to this presentation contains additional information for stakeholder reference. That concludes our prepared remarks. We are happy to answer any questions you have.