February 2019

NCUA's supervisory stress test (SST) consists of baseline, adverse, and severely adverse scenarios, which are to be provided to covered credit unions by February 28th of each year. As in past SST exercises, NCUA's 2019 SST scenarios closely follow the domestic baseline, adverse, and severely adverse scenarios published by the Federal Reserve Board for the Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act stress test (DFAST) exercises.

The baseline scenario follows a profile similar to the January 2019 consensus projections from *Blue Chip Economic Indicators*. The adverse and severely adverse scenarios describe hypothetical sets of conditions designed to assess the resilience of credit unions under adverse conditions. These scenarios do not represent forecasts of NCUA or the Federal Reserve Board.

The 2019 Adverse and Severely Adverse scenarios represent economic stress similar to 2018 scenarios, but differ in a couple key attributes. 2019 yield curves are not as steep as in 2018. Unemployment reaches a similar peak; however, the increase to reach that peak is greater due to lower initial unemployment rates.

Each scenario is summarized as follows:

<u>Baseline Scenario</u> - The baseline scenario is a moderate economic expansion:

- Real GDP grows between 1.5 and 2.5 percent. GDP growth fluctuates within this range for the nine testing quarters;
- Unemployment briefly falls but then slightly increases;
- CPI inflation picks up in 2019 Q2 to 2.3 percent and remains relatively flat with only small fluctuations;
- Short-term Treasury rates increase from 2.5 percent at the beginning of 2019 and increase to 2.8 percent by the end of the year, and remain flat;
- 10-year Treasury securities rise from 2.9 percent to 3.4 percent at the beginning of 2021;
- Prime rates increase in line with short-term Treasury rates. Mortgage rates and corporate bond yields rise in line with long-term Treasury rates;
- Equity prices increase by about an average of 5 percent per year and equity volatility decreases slightly;
- Nominal housing prices rise about 2.5 percent through 2020, and slightly increase through 2021. Commercial real estate rapidly appreciates in 2019, and then moderates to about 3 percent.

<u>Adverse Scenario</u> – The adverse scenario is characterized by weakening economic activity throughout the scenario. The economic downturn is accompanied by declines in long-term rates and flattening yield curves.

- Real GDP falls for the first four quarters and quickly picks up momentum;
- Unemployment rises steadily, peaking at 7 percent in the second half of 2020, then gradually falling but remaining elevated through the horizon;
- CPI inflation initially quickly increases from 1.3 percent to 2 percent, and remains around 2 percent;
- Short-term Treasury rates immediately fall and remain near zero to the end of the scenario;
- 10-year Treasury rates slowly increase through the forecast horizon, finishing over 100 basis points higher than at the start;
- Spreads between investment grade bonds and long-term Treasury yields increase to 3.7 percent, and mortgage spreads increase to about 2.6 percent above 10-year Treasuries in the first four quarters, then gradually decline;
- Equity prices fall more than 20 percent in 2019, and then slowly increase in the last 9 quarters of the forecast horizon;
- Housing prices commercial real estate prices fall through the 9-quarter testing period and modestly recover by the end of the horizon.

Severely Adverse Scenario – The severely adverse scenario is characterized by a severe global recession with heightened stress on corporate debt and commercial real estate.

- Real GDP declines for the first seven quarters of the scenario and rapidly increases to 4.6 percent by the end of 2021;
- Unemployment increases from 3.8 percent at the start of the period to 10 percent in 2020 Q3. Unemployment slightly falls through the remainder of the period, but remains high;
- Inflation initially falls to 1.2 percent, and then slowly increases through the testing period 2.1 percent at the end of 2021;
- Short-term Treasury rates immediately fall and level out at 0.1 percent in 2019 3Q;
- The 10-year Treasury rate immediately falls to 0.8 percent and increases to 1.5 percent by the end of the testing period and 1.8 percent at the end of the forecast horizon;
- Investment grade spreads increase to 5.5 percent by 2019 Q4, and mortgage rate spread over the 10-year Treasury widens to 3.4 percent over the same time. Both rate spreads gradually narrow through the horizon;
- The House Price Index falls by more then 25 percent and the Commercial Real Estate Price Index falls by 35 percent in the first nine quarters;
- Equity prices fall sharply in 2019 Q2 and don’t begin to increase until 2020 Q1.