



March 25, 2011

NCUA Proposal on Managing Interest Rate Risk

Executive Summary

- The National Credit Union Administration Board is seeking comments, through **May 23, 2011**, on a proposal that addresses requirements for:
 - a written policy on interest rate risk (IRR); and
 - an IRR management program.
- Click [here](#) for a copy of the proposal.
- There are asset-size and activity triggers for how the IRR requirements would apply:
 - Federally insured credit unions with less than \$10 million in assets would not be required to have a written policy.
 - Federally insured credit unions with assets of \$10 million or more but not exceeding \$50 million would have to meet the written policy requirements if all of their first mortgages held in portfolio plus total investments with maturities of greater than five years are at least 100% of their net worth. (Credit unions in this asset range would not have to have a written policy if they have less than 100% of their net worth in first mortgages and total investments with maturities of over five years.)
 - Federally insured credit unions with assets over \$50 million would have to meet the written policy requirements.
- Compliance with the proposal would be part of a credit union's overall asset liability management and would be a condition of receiving and maintaining federal deposit insurance.
- The proposal includes draft guidance for developing and maintaining an IRR written policy and management program; the draft guidance is an appendix to the proposal.
- CUNA has concerns about the extent to which a new regulation in this area should be imposed on credit unions, even though appropriate and reasonable management of interest rate risk at all credit unions is very important.
- CUNA will be reviewing this proposal in detail with our Examination and Supervision Subcommittee.

- Credit unions are encouraged to comment on this proposal and to email your views to CUNA as soon as possible by contacting Mary Dunn or Luke Martone at lmartone@cuna.com.
- Credit unions wishing to comment may email their letters to NCUA at regcomments@ncua.gov and include “[Your name] -- Comments on Proposed Rulemaking for Part 741” in the email subject line. Letters may also be filed on line through NCUA’s website www.ncua.gov or mailed to Mary Rupp, Secretary of the Board, NCUA, 1775 Duke Street, Alexandria, VA 22314-3428.

Highlights of the Proposal

Section 741.3 of NCUA’s Rules and Regulations addresses the qualifications for obtaining and maintaining federal share insurance from the National Credit Union Share Insurance Fund. These provisions currently contain requirements for written lending and investment policies.

The proposal would amend Section 741.3 to address requirements for a written IRR policy and an effective IRR management program as conditions to the NCUSIF insurance. The extent to which a credit union complies with these requirements would be a factor in assessing the safety and soundness of the credit union’s financial condition and polices.

What is Interest Rate Risk (IRR)?

The proposal provides that “interest rate risk” is the:

- “Vulnerability of a credit union’s financial condition to adverse movement in market interest rates.” It also notes that credit unions have to address IRR from several sources, which include repricing risk, yield curve risk, spread risk, basis risk and options risk.

The proposal also states that NCUA believes credit unions should have a written policy that expressly states the credit union’s IRR tolerance and an effective IRR program that “identifies, measures, monitors and controls IRR.” Such a program is an “essential component of safe and sound credit union operations.”

Why Does NCUA Feel This Proposal is Necessary?

NCUA does not provide much discussion as to why the board believes this new rule is necessary, especially since the agency issued joint guidance on IRR management with the other federal financial regulators in January 2010. We are not aware that other federal financial regulators have developed a similar proposal.

The proposal notes that “IRR has risen at credit unions due to changes in balance sheet composition and increased uncertainty in the financial markets. The Board therefore believes it is appropriate to create a regulatory requirement addressing the policy and practice of IRR management at federally insured credit unions supported by clear and comprehensive guidance.”

The agency’s board action memorandum presented to the board for its discussion of the proposal provides some more rationale for the proposal; the memo is available here: <http://www.ncua.gov/GenInfo/BoardandAction/DraftBoardActions/2011/Mar17/Item5a11-0317.pdf>.

NCUA estimates that about 25% of credit unions, or around 800, will need to develop a written IRR policy and others may need to revise this to conform to the rule if it is adopted.

How Would the Proposal Apply?

Covered federally insured credit unions would have to have an effective IRR management program that is consistent with the proposed guidance, which is discussed in greater detail below.

As indicated above in the Executive Summary, there are triggers for the applicability of the proposed rule, which are also addressed in the proposed guidance. The triggers are based on the credit union’s asset size and the extent of its mortgage loans held in portfolio and longer-term investments (over five years).

- A first mortgage loan would be considered to be held in portfolio if the credit union has not demonstrated the intent and ability to sell the loan to an independent third party within 120 days.
- Investments with maturities greater than five years are those reported by the credit union to have maturities of five-ten years and greater than ten years in the most recent call report.

What are the Provisions on the Written IRR Policy?

- The policy may be a separate document or part of the credit union’s policy on ALM, investments, funds management, liquidity, or other policies.
- The document must clearly describe the credit union’s IRR policy.
- The board of directors is responsible for the adequacy of the IRR policy, which should be consistent with the credit union’s business strategies.
- It should reflect the credit union board’s risk tolerance, based on the credit union’s financial condition and risk measurement systems, consistent with the credit union’s balance sheet structure.

- The policy should state actions and authorities required for exceptions to the policy and limitations under it.
- The policy should establish responsibilities for identifying, measuring, monitoring, controlling and reporting IRR and establish risk limits.

In addition, a written IRR policy should, according to the proposed guidance:

- Identify committees, persons or other parties responsible for review of the credit union's IRR exposure;
- Direct appropriate actions to ensure management takes steps to manage IRR so that IRR exposures are identified, measured, monitored, and controlled;
- State the frequency with which management will report on measurement results to the board to ensure routine review of information that is timely (e.g. current and at least quarterly) and in sufficient detail to assess the credit union's IRR profile;
- Set risk limits for IRR exposures based on selected measures (e.g. limits for changes in repricing or duration gaps, income simulation, asset valuation, or net economic value);
- Choose tests, such as interest rate shocks, that the credit union will perform using the selected measures;
- Provide for periodic review of material changes in IRR exposures and compliance with board approved policy and risk limits;
- Provide for assessment of the IRR impact of any new business activities prior to implementation (e.g. evaluate the IRR profile of introducing a new product or service); and
- Provide for annual evaluation of policy to determine whether it is still commensurate with the size, complexity, and risk profile of the credit union.

The IRR policy should also help maintain risk exposures within prudent levels.

Examples of limits provided by NCUA are:

- GAP: less than + or – percent change in any given period or cumulative over 12 months.
- Income Simulation: Net Interest income after shock change less than 20 percent over any 12-month period.
- Asset Valuation (or Net Economic Value): After shock change in book value net worth less than 25 percent or after shock value of net worth greater than 6 percent.

However, the proposal also notes that the examples are only for illustrative purposes and that management should set its own limits that are reasonably supported.

What Does the Proposed Guidance Provide for an Effective IRR Program?

Duties of the Credit Union's Board

- The credit union's board is responsible for approving the policy, major strategies and prudent IRR limits; understanding the level and nature of the IRR at the credit union is essential.
- The board is expected to ensure management executes an effective IRR program.
- The board is required to annually assess the IRR program to determine if it sufficiently identifies, measures, monitors, and controls IRR. The board may consider obtaining professional advice and training to enhance its IRR oversight.

Duties of the Management

- The management implements the board's IRR policy. The management should:
 - Develop and maintain adequate IRR measurement systems;
 - Evaluate and understand IRR risk exposures;
 - Establish an appropriate system of internal controls (e.g. separation between the risk taker and IRR measurement staff);
 - Allocate sufficient resources for an effective IRR program. For example, a complex credit union with an elevated IRR risk profile will likely necessitate a greater allocation of resources to identify and focus on IRR exposures.
 - Develop and support competent staff with technical expertise commensurate with their IRR program;
 - Identify the procedures and assumptions involved in implementing the IRR measurement systems; and
 - Establish clear lines of authority and responsibility for managing IRR; and
 - Provide a sufficient set of reports to ensure compliance with board approved policies.

Significant changes in assumptions, measurement methods, tests performed, or other aspects involved in the IRR process should be documented and brought to the attention of those responsible, according to the proposed guidance.

What Does IRR measurement and Monitoring Entail under the Proposed Guidance?

Credit unions should have IRR measurement systems that capture and measure all material and identify sources of IRR. An IRR measurement system quantifies the risk contained in the credit union's balance sheet and integrates important sources of IRR to facility management of the risk exposure.

The selection and assessment of the appropriate IRR measurement system is the responsibility of credit no board and management. Management should:

- Rely on assumptions that are reasonable and supportable;
- Document any changes to assumptions that should be based on observed information;
- Ensure calculation techniques are appropriate in rigor and use accepted financial concepts;
- Monitor positions with uncertain maturities, rates and cash flows, such as nonmaturity shares, fixed rate mortgages where prepayments may vary, adjustable rate mortgages, and instruments with embedded options, such as calls; and
- Require any interest rate measures and tests to be sufficiently rigorous to capture risk.

The proposal provides a discussion of IRR measurement methods, which include:

- GAP analysis (reports the mismatch between rate sensitive assets and rate sensitive liability over a given time);
- Income Simulation (estimate earnings exposure to changes in interest rates);
- NCUA Asset valuation Tables (prepared quarterly by NCUA, the table helped to provide an indication of a credit union's potential IRR based on their risk associated with asset categories of greatest concerns, such as mortgage loans and investment securities);
- Net Economic Value (which measures the effect of interest rates on the market value of net worth by calculating the present value of assets minus the present value of liabilities).

The proposal also provides a discussion of the components of IRR measurement methods, as critical decisions in the establishment of the IRR measurement involve these components. They include but are not limited to:

- The chart of accounts;

- Whether data aggregation results in information that is too imprecise;
- Account attributes such as principal types, rate types, rate indexes, repricing internal, new volume maturity distribution, accounting accrual basis, prepayment driver and discount rate; and
- Assumptions such as interest rate scenarios, projected balance sheet volumes, prepayment rates, repricing sensitivity, and decay rates of nonmaturity shares.

In addition, the proposal provides a discussion of internal controls. If possible, those responsible for risk taking should not be involved in risk measurement at the credit union. Staff responsible for maintaining controls should periodically assess the overall IRR as well as compliance with the credit union’s policy. The proposal provides that audit findings should be reported to the credit union’s board or supervisory committee with recommendations for corrections and timeframes.

The proposal also discusses decision making regarding IRR. Management should utilize the results of the IRR measurement systems in changing balance sheet structure, funding, pricing strategies, and business plans.

The proposal provides standards for assessing the IRR policy and effective of the credit unions IRR programs. The standards are:

Policy	Adequate	Inadequate
Board oversight	Policy is consistent with credit union strategy, and the board states actions required to address policy exceptions.	Policy is not consistent with credit union complexity. Board has not reviewed limits specified in policy and does not require management to take corrective action when policy limitations are exceeded.
Responsible parties identified	A committee or management is designated to review and monitor IRR.	No committee or individual specified to review credit union’s IRR exposure.
Direct appropriate action to measure, monitor, control IRR	Policy states all actions that are sufficient to manage IRR.	Omissions in policy cause material deficiency in controlling risk (e.g. method of measuring IRR is not identified or risk measurement not required with stated frequency).
Reporting frequency specified	Reporting of results is required with sufficient frequency to alert management to emerging IRR.	Reporting is infrequent and does not provide adequate detail to control IRR (e.g. semi-annual reporting on an aggregate balance sheet).
Risk limits stated with appropriate measures	Risk limits are established and are appropriate for the size and complexity of the credit union.	Key risk limit omitted from policy (e.g. NEV ratio or volatility post shock, NII post shock, or sensitivity gap at stated period), or limit is not reasonable (e.g. limits allow IRR measures to approach dangerously low levels under plausible interest rate scenarios).
Tests for limits	Tests substantially display the level and range of credit union IRR.	Tests do not indicate level or source of risk (e.g. NEV @ only +/-100 bps, or repricing gap only at one month).

Review of material IRR changes	Any changes beyond a stated level are reported to management and, where appropriate, the Board.	Review is required, but need for compliance with policy limits and corrective action are unclear.
Impact of new business	IRR impact of all business initiatives is required where these will affect future IRR.	The credit union does not evaluate the impact of new business on its IRR profile and is at risk from new business booked.
Periodic policy review	Review by Board required annually to ensure continued relevance and applicability of policy to management of IRR.	Policy review is required only if risks are unchanged, at the Board's discretion.
IRR Oversight & Management	Adequate	Inadequate
Oversight	Board approves policy and strategies and understands IRR faced by its own credit union.	Board is aware of the types of IRR present to credit unions in general, but does not have knowledge of the IRR risks associated with the credit union.
Oversight assessment of program effectiveness	Board periodically evaluates program effectiveness by monitoring management's IRR knowledge, using professional advice.	Board substantially relies on annual third party review to determine the adequacy of oversight and governance.
Choice of IRR measurement systems	Management selects and maintains systems which are able to capture the complexity of IRR risks.	Systems used by the credit union do not capture IRR (e.g., balance sheet contains material options in investments, mortgage loans or core deposits, which the system cannot capture - calls, prepayments, or administered rates).
Evaluation of IRR risk exposures	Credit union understands all material IRR exposures and evaluates these accordingly relative to credit union strategy.	Management relies on outside parties to evaluate credit union's IRR and cannot effectively explain the IRR measurement method or the results.
System of internal controls	Internal controls encompass and effectively evaluate programs that manage elements of IRR at the credit union.	Internal audit has not identified or addressed the correction of IRR deficiencies (e.g. processes for tracking changes in measurement assumptions, such as gap repricing of core deposits).
IRR resource management	Credit union has allocated initial or additional qualified staff resources sufficient to manage IRR by means that address sources of risk.	Credit union IRR exposure has materially increased without allocating additional, qualified staff, consequently IRR exposures are not identified or properly measured.
Expertise of IRR program staff	Staff responsible correctly identifies sources of IRR and can quantify these risks.	Credit union relies on staff who do not understand or are not familiar with IRR at the credit union (e.g., management cannot explain the impact on IRR of overstating core deposit premiums).
Procedures and assumptions of IRR measurement systems	Credit union identifies reasonable procedures and supportable assumptions.	Management delegates assumptions to a third party and has no procedure to review the reasonableness of the assumptions.
Accountability of IRR management	Responsibility for managing IRR is specific and clearly delineated.	Responsibility for managing IRR is too broad, or unclear, or not recognized by management
Transparency of changes in assumptions, methods, and IRR tests.	Management requires clear disclosure of relevant changes in all material assumptions and methods.	Changes in assumptions are not tracked, or monitored or transparent to those evaluating efficacy of IRR system.

IRR Measurement and Monitoring	Adequate	Inadequate
Reasonable and supportable assumptions	Credit union carefully evaluates all assumptions and assesses the sensitivity of results relative to each key assumption.	Results are highly dependent on key assumptions that have not been researched or demonstrated to be supportable (e.g. mortgage prepayments do not reflect extension risk and core deposit premiums overstate or do not indicate reasonable maturities).
Assumption changes from observed information	All material changes in assumptions are based on tested internal data or reliable industry sources.	Assumptions are not tested and changes are not supported by any associated data on which the credit union relies.
Rigor of calculations and conformity of concepts	Techniques used appropriately capture complexity of balance sheet instruments.	Methods to attribute cash flows, and rate sensitivities are based on incorrect techniques (e.g. misuse of statistical correlations).
Positions with uncertain maturities, rates and cash flows	Activity is monitored on a regular basis in order to validate reasonableness of modeling assumptions.	Actual behavior is not monitored or compared to projected behavior.
Rigor of interest rate measures and tests	Measures and tests employed capture the material risks embedded in the credit union's balance sheet.	Measures and tests employed do not capture material risks embedded in the balance sheet (e.g., rate shocks do not trigger the embedded options in some products).
Components of IRR Measurement Methods	Adequate	Inadequate
Chart of accounts	A sufficient number of accounts have been defined to capture key IRR characteristics inherent within each product.	Accounts/products with different IRR characteristics are modeled as one account/product (e.g. 15- and 30-year fixed-rate mortgages, with various coupons and prepayment behaviors).
Data aggregation	The level of data disaggregation is sufficient given the credit union's complexity and risk exposure (e.g. instrument level processing).	Data is combined for similar products with a wide range of variables, producing misleading weighted average terms (e.g. combining fixed-rate mortgages with coupons ranging from 4% to 8%, and modeling as a 6% mortgage).
Account attributes	Account set-up is appropriate to allow for the capture of key IRR characteristics.	Account set-up fails to identify key IRR characteristic (e.g. adjustable-rate mortgages are modeled without periodic and lifetime caps and floors).
Discounting methodology	Methodology used properly calculates the value of the asset or liability being modeled.	Methodology used does not accurately value assets or liabilities (e.g., discount rates or maturities or cash flows are incorrect in discounting calculations).
Assumptions	Credit union carefully evaluates all assumptions and assesses the sensitivity of results relative to each key assumption.	Results are highly dependent on key assumptions that have not been researched or demonstrated to be supportable (e.g. mortgage prepayments do not reflect extension risk and core deposit premiums overstate or do not indicate reasonable maturities).
Internal Controls	Adequate	Inadequate
Internal assessment of IRR program	Staff are identified and have annually assessed policy and program to correct any weaknesses.	There is no specified review action for requiring periodic evaluation of IRR program effectiveness.

Compliance with policy	IRR program is evaluated semi-annually for any policy exceptions, including compliance with approved limits.	Exceptions to policy occur occasionally and these are not noted by the internal control process.
Timeliness and accuracy of reports	Reports that are routinely provided to management and the Board successfully communicate material IRR exposure of the credit union.	Reports fail to specify some material risks, and some scheduled reports are not produced.
Audit findings reported to board or supervisory committee	IRR program deficiencies and policy exceptions are reported to the Board in accordance with the policy.	IRR program effectiveness is not part of audit review. No findings occur.
Decision-making and IRR	Adequate	Inadequate
Use of IRR measurement results in operational decisions	Measured IRR results form part of the credit union's ongoing business decisions and are substantive considerations routinely included in the business decision process.	IRR exposure discussion occurs only as deemed relevant in the annual strategic process.
Escalated use of results when IRR exposure is raised or approaching limits	Procedure specifies review escalation at specific levels with increasing contingency triggers close to limits.	IRR results are secondary in addressing IRR contingencies. Credit union relies on ad hoc response driven by market and customer perceptions.
Application to reduce elevated levels of IRR	Credit union utilizes IRR results to clearly define and formulate response to increased IRR levels.	IRR system results are not used to address balance structure, funding or pricing strategies.

Additional guidance for large credit unions with complex or high-risk balance sheets as discussed by the proposal, should consider the following:

- The IRR Policy could provide for the use of outside parties to validate the tests and limits commensurate with the risk exposure and complexity of the credit union;
- IRR measurements could provide compliance with policy limits as shown both by assessing risks to earnings and net economic value of equity under a variety of defined and reasonable interest rate scenarios;
- The effect of changes in assumptions on IRR exposure results (e.g. the impact of slower or faster prepayments on earnings and economic value); or,
- Enhanced levels of separation between risk taking and risk assessment (e.g. assignment of resources to separate the investments function from IRR measurement, and IRR monitoring and oversight).

Definitions

The proposal also provides a list of definitions, which are:

- **Basis risk:** The risk to earnings and/or value due to a financial institution's holdings of multiple instruments, based on different indices that are imperfectly correlated.

- Interest rate risk: The risk that changes in market rates will adversely affect a credit union's net economic value and/or earnings.
- Option risk: The risk to earnings and/or value due to the effect on financial instruments of options associated with these instruments.
- Repricing risk: The repricing of assets or liabilities following market changes can occur in different amounts and/or at different times. This risk can cause returns to vary.
- Spread risk: The risk to earnings and/or value resulting from variations through time of the spread between assets or liabilities to an underlying index such as the Treasury curve.
- Yield curve risk: The risk to earnings and/or value due to changes in the level or slope of underlying yield curves.

Questions to Consider

1. Do you agree credit unions need a new rule on interest rate risk?

Yes_____ No_____

Why do you agree or disagree with NCUA? _____

2. Has NCUA provided sufficient rationale for the new rule?

Yes_____ No_____

3. If this rule is adopted, do you support the triggers for how the written policy requirements would apply?

Yes_____ No_____

Please explain your response. _____

4. Do you agree with the requirements for the written policy (for those CUs to which these requirements would apply)?

Yes____ No____

Please explain your response. _____

5. NCUA estimates that only 800 credit unions will have regulatory burdens associated with the written policy requirements and the burden for each of them will be 16 hours. Do you agree with that?

Yes____ No____

What do you think the burden will be for your credit union? _____

6. Will your credit union have to create or modify its written policy to conform to the proposal's requirements?

Yes____ No____

How much time will that take and what other resources of the credit union will be used to comply? _____

7. Is the guidance on the IRR management program useful?

Yes____ No____

Please explain your response. _____

8. Should compliance with the proposal be a requirement for federal share insurance?

Yes____ No____

Please explain your response. _____

9. Since the proposed guidance is included as an appendix to the rule, does that create confusion as to what extent credit unions will be required to follow the guidance precisely?

Yes____ No____

Please explain your response. _____

10. The proposal states that IRR policies and management programs must be individualized. Yet, does this proposal and guidance leave sufficient flexibility to credit unions to adopt IRR policies and management programs that reflect this individuals risk profile?

Yes____ No____

Please explain your response. _____

11. Should credit unions be singled out for a new rule in this area when banks have not been? Is the joint guidance that NCUA issued with the other federal financial regulators in January 2010 sufficient?

Yes____ No____

Please explain your response. _____

12. Instead of a new rule for all federally insured credit unions, would it be preferable to address IRR management issues with credit unions that do not have written polices and/or effective IRR management programs?

Yes____ No____

Please explain your response. _____

13. Do you agree with the proposal's allocation of responsibilities between a credit union's board and management on IRR management?

Yes____ No____

Please explain your response. _____

14. Do you agree with the proposal's discussion of IRR measurement and monitoring?

Yes____ No____

Please explain your response. _____

15. Do you agree with the standards for assessing an IRR Policy and Management Program?

Yes____ No____

Please explain your response. _____

