NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **May 2012** **LETTER NO.: 12-CU-05**

TO: **All Federally Insured Credit Unions**

SUBJ: **Interest Rate Risk Policy and Program Requirements**

ENCL: **(1) Appendix A - Examination Questionnaire**

Dear Board of Directors and Chief Executive Officers:

Beginning on September 30, 2012, certain federally insured credit unions (FICUs) will be required to adopt a written policy on interest-rate risk (IRR) management and a program to implement it effectively.[1]

This rule affects only 45% of credit unions, yet covers 96% of credit union assets. Boards and management of affected credit unions must be vigilant and well-prepared before interest rates rise. Exposed credit unions without appropriate interest rate risk policies pose unacceptable and preventable risks to the National Credit Union Share Insurance Fund.

However, our standard for interest rate risk policies is not one-size-fits-all. We realize that exposed credit unions have different risk profiles. So while the rule provides guidelines for policies, we are also providing flexibility for credit union managers and board members to develop their own policy – and we are giving affected credit unions several months to comply.

This letter answers frequently asked questions since the rule was finalized in January. If you have further questions, you may contact your examiner, regional office, or NCUA's Office of Examination and Insurance (E&IMail@ncua.gov).

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[1] This new interest rate risk management provision is found in Part §741.3(b)(5)(i) of NCUA Rules and Regulations.

Is your credit union subject to the new requirements?

You are subject to the requirements of the final rule if:

- Your credit union's assets exceed $50 million, as shown by your most recent Call Report filing; or
- Your credit union's assets are equal to or greater than $10 million but do not exceed $50 million and the sum of your first mortgage loans held and investments with maturities exceeding five years is equal to or greater than 100% of your net worth at quarter end.

Otherwise, you are not subject to the rule requirements. We are mindful of the need to avoid unjustified regulatory burden. We recognize past efforts to develop sound IRR policy and believe many FICUs already meet the rule requirements.

To promote transparency and facilitate implementation for FICUs with higher IRR exposure, we included comprehensive guidance on developing an IRR policy and an effective IRR management program in an appendix to the rule. This guidance describes widely accepted sound practices in IRR management and prior supervisory guidance such as the FFIEC Advisory on Interest Rate Risk Management discussed in NCUA Letter to Credit Unions 10-CU-06 (May 2010).

What are the reasons for this rule?

The rule will promote safe and sound management of IRR at credit unions and provide clear expectations for credit unions and our examination staff.

As noted in the rule preamble, FICU exposure to IRR from first mortgage loans and long-term investments grew substantially during the last interest-rate cycle. Indeed, aggregate exposure of FICUs by the SIRRT ratio increased from 199% at year-end 2005 to a peak of 271% in March 2011.[2] We expect exposure to remain high for some time because of the longer-term nature of assets in the SIRRT numerator.

We urge you to remain vigilant in managing IRR exposures. Long and short-term interest rate levels are currently at historic lows. A return of interest rates to pre-2007 levels will present significant challenges as you seek to manage net interest margins or net economic value.

How does this rule affect previous guidance issued by NCUA?

The rule provides a clear framework to help you to address IRR.

[2] The ratio of first mortgages and investments with maturities exceeding five years to net worth is called the Supervisory Interest Rate Risk Threshold (SIRRT). It has been added to the Financial Performance Report and will be added to the AIRES database by the second quarter of 2012.

In the past, NCUA and the other financial regulators provided guidance to financial institutions on managing IRR.[3] We also provided guidance to FICUs in various ALM subject areas with interest-rate risk implications.[4]

The guidance provided in the appendix of the current IRR rule complements existing guidance by describing best practices for your credit union to consider as you write IRR policy and construct IRR management programs. It deals first with the responsibilities of boards and management, then addresses IRR measurement and monitoring, internal controls, and the integration of IRR results into your credit union's decision making. Finally, the guidance provides additional considerations if your credit union is large with complex or high-risk balance sheets.

Guidance in previous Letters to Credit Unions, by contrast, was directed at individual and distinct areas of IRR. Accordingly, these letters covered risks associated with real-estate lending and concentrations, liquidity, highly rate-sensitive and volatile funding, and non-maturity shares. Each of these factors presents its own risk for your credit union as explained in the separate letters issued. Guidance in the current IRR rule, on the other hand, addresses the means by which your credit union can manage these risks through an IRR management program, within the boundaries of a policy you adopt.

How will NCUA implement the rule?

Our objective is to implement the rule consistently while taking into account differences among institutions. Examiners will be expected to consider the size, complexity and risk exposure of each FICU when evaluating written IRR policies and risk-management programs. As the guidance in the rule states, "an effective IRR management program identifies, measures, monitors and controls IRR." Such a program is central to the safety and soundness of your credit union because it permits you to make decisions that take into account the potential impact of changing interest rates on operations.

We prepared a new IRR questionnaire for examiners to use when evaluating FICU policies and programs. That questionnaire is enclosed. It replaces the existing questionnaire and procedures referenced in Letter to Credit Unions 00-CU-10, Asset Liability Management Examination Procedures (November 2000).

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3 Interagency Advisory on Interest Rate Risk Management, Jan. 6, 2010; Interagency Advisory on Interest Rate Risk Management, Frequently Asked Questions, Jan. 12, 2012.

4 Letters to Credit Unions: 99-CU-12, Real Estate Lending and Balance Sheet Risk Management, Aug. 1999; 00-CU-10, Asset Liability Management Examination Procedures, Nov. 2000; 00-CU-13, Liquidity and Balance Sheet Risk Management Dec. 2000; 01-CU-08, Liability Management - Highly Rate-Sensitive and Volatile Funding Sources, July 2001; 01-CU-19, Managing Share Inflows in Uncertain Times, Oct. 2001; 03-CU-11, Non-Maturity Shares and Balance Sheet Risk, July 2003; 03-CU-15, Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios, Sept. 2003; 06-CU-16, Interagency Guidance on Nontraditional Mortgage Product Risk, Oct. 2006; 10-CU-06.

The new questionnaire follows the steps of the guidance in the new rule and explains the focus of each question. It uses the scope determinant in the previous questionnaire but adds tests for exposures to short-term liabilities and complex assets. Our pricing tables will be an optional resource for examiners and you. The questionnaire accords with minimum scope requirements for all examinations. We will publish the new questionnaire on our website.

<u>What should credit unions do to prepare?</u>

We encourage you to review the new IRR rule on the NCUA website located at http://www.ncua.gov/Legal/Regs/Pages/FIRegulations.aspx.

If your credit union holds between $10 million and $50 million in total assets, you should determine whether the new rule applies to you as determined by your SIRRT ratio on the most recent Financial Performance Report.

You should also review the guidance in the appendix of the rule prior to the effective date on September 30, 2012, and assess whether your credit union should revise or enhance existing IRR policies and management programs.

<u>What additional actions is NCUA taking?</u>

To ensure examiners apply the IRR rule as intended in the context of your business objectives and risk profiles, we have distributed the interest-rate risk questionnaire to our regional offices.

We also conducted a webinar for federal and state examiners to train them on consistently applying the rule, and provided training for our examiners at the NCUA National Training Conference.

We will also host a webinar for credit unions to further address frequently asked questions.

We are committed to effective execution of the rule and its objectives. We encourage you to engage your examiners while implementing or revising your IRR program.

Sincerely,

/s/

Debbie Matz
Chairman

Enclosure