DCU BULLETIN

Division of Credit Unions

Washington State Department of Financial Institutions

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Focus on Interest Rate Risk (IRR) Management

The Division of Credit Unions (Division) is enhancing its examination procedures on interest rate risk (IRR). Although credit unions have successfully managed IRR during previous interest rate cycles, the current low rate environment is unprecedented. With interest rates poised to rise, the Division is monitoring how effective credit unions with high IRR are at identifying, measuring, monitoring, and controlling the impact of changing interest rates to their balance sheet and earnings. The Division may be contacting your credit union to inquire about balance sheet re-structuring plans if our analysis shows a high IRR rating.

To illustrate the risks that may be inherent in a credit union's balance sheet, consider the following risk indicators, as published in NCUA's Letter to Credit Unions #04-CU-02. For 2003:

- More than 89% of shares reprice in less than one year;
- Held-to-maturity and available-for-sale securities account for half the investment portfolio. Large portions of these portfolios include securities with some level of optionality, including prepayment or extension risk;
- Longer term investments (terms over one year) increased more than 28% during a falling interest rate environment;
- Liquidity (defined as cash, cash on deposit, cash equivalents, and investments less than one year) decreased by almost 6%;
- Net interest margins declined to 3.4% of average assets, and are at near historic lows; and
- First mortgage real estate loans account for almost one-third of all credit union loans, with almost three quarters of those being fixed rate, and credit union made four times the amount of fixed rate 1st mortgage real estate loans compared to variable rate.

Board Responsibilities

The Board has the fiduciary responsibility to ensure that the credit union operates in a safe and sound manner and remains financially healthy. Given the current rate environment it is important that each Board devotes adequate time to consider the level of IRR in their credit union. For all credit unions, the Division expects the Board of Directors to accomplish the following:

1. ensure that policies for managing IRR are adequate for the size and complexity of the balance sheet;
2. set risk exposure policy limits at prudent levels;
3. receive timely reports sufficient to determine how well management identifies, measures, and controls IRR.

Because the ability to control IRR requires a clear understanding of the earnings and capital at risk, an effective policy should define the maximum reduction in earnings and net worth acceptable to the Board.

For credit unions with moderate to high IRR, our examiners will be interested in the Board's understanding of the credit union's IRR model results, assumptions used, and requirements for validation of model results. (See discussion in Management section below on IRR models.)

Management Responsibilities

Management must have suitable controls in place to ensure the credit union does not become subject to IRR in excess of the Board's approved policy limits. Management is responsible for structuring the credit union's balance sheet in a manner consistent with the Board's IRR policy. Management should accomplish this objective through an IRR strategy that is consistent with other strategic and business plan objectives. There may be instances when steps taken to manage IRR conflict with or limit the credit union's ability to attain other business goals. For example, purchasing longer-term, higher yielding assets may enhance the net income in the short term, but may be detrimental to the long-term IRR profile and cause problems in the future. Effective model results require the use of strategies that are consistent with strategic plans and the credit union's will to implement them. Otherwise, model results will not be useful. These potential conflicts require management to have a full understanding of the reasons for adopting a given strategy, as well as the possible short and long-term impact to the financial health of the credit union.

Management is responsible for implementing systems that can identify IRR and measure it as accurately as possible. An effective IRR identification process provides an early warning system to identify risk before options become too limited. For credit unions with ALM models, this involves shocking the balance sheet to account for possible changes in interest rates. The measurement of risk based on a 300 basis point change in rates, the default setting in many models, may be inadequate. For example, in 2001, short-term interest rates changed 460 basis points. Since 1971, short-term interest rates have been ranged between 4% and 9% eighty percent of the time. For those credit unions with high levels of risk, worst-case scenarios and their results should be evaluated. The potential for rapidly rising rates, above 300 basis points, should be considered.

IRR models can provide a wide variety of measurement results based on assumptions and data placed into the model. The IRR policy should require a certain amount of caution in setting the model assumptions. Validating the assumptions and model results is essential. This requires management to reconcile actual operating results and market values with those projected in the prior period IRR analysis. Setting valid assumptions involves identifying realistic expected behaviors. The following are important considerations:

- ✓ An assumption of high levels of core deposits means that these deposits will not leave even if dividends are below market;
- ✓ An assumption of selling lower earning assets when rates rise means that the credit union is willing to absorb losses on the sale; and
- ✓ Immediate re-pricing of assets, with no delay, means that the credit union has the ability to immediately originate new loans at the new rates.

Identifying the sources of variances will not only improve the credit union's forecasting ability, but will add to the Board and management understanding of the major factors driving the credit union IRR exposure.

The Division encourages management to review additional reference material about IRR. For example, NCUA has written Letters to Credit Unions regarding specific concerns about IRR. Copies are available on the NCUA website at http://www.ncua.gov/letters/letters.html

- 99-CU-12, August 1999, "Real Estate Lending and Balance Sheet Management;"
- 00-CU-13, December 2000, "Liquidity and Balance Sheet Risk Management;"
- 01-CU-08, July 2001, "Liability Management – Highly Rate Sensitive and Volatile Funding Sources;"
- 01-CU-19, October 2001, "Managing Share Inflows in Uncertain Times,"
- 03-CU-11, July 2003, "Non-Maturity Shares and Balance Sheet Risk

Regulatory Concerns and Updated Examination Procedures

Circumstances that will cause supervisory concerns for the Division include:

- ❑ A nonexistent or inadequate IRR policy,
- ❑ Unacceptably high or unspecified limits on IRR exposure,
- ❑ Noncompliance with the Board's IRR policy, and
- ❑ Weaknesses in identification, measurement, monitoring, and controlling of IRR.

The Division is currently assessing which credit unions have a high IRR exposure. We are also in the process of updating our supervision and examination procedures to more adequately evaluate current risks associated with the economy, balance sheet structure, and IRR management. **We will update procedures to account for differences in the complexity and IRR risk levels for state credit unions. We expect to have these procedures in place by the end of August 2004.**

The updated procedures will address both onsite exams and offsite monitoring. For credit unions with high IRR and a complex balance sheet, the Division may schedule a limited scope onsite IRR exam. If the credit union is already scheduled for a regular exam this summer or fall, the IRR exam will be part of the regular examination. For all other high IRR credit unions, a limited scope exam on IRR may be scheduled. An Asset Liability Management (ALM) Specialist will perform the IRR exam review.

Survey

To assist us with our initial determination of your credit union's IRR profile, we ask that you complete the attached survey. Please fax it to the Division at (360) 704-6901 no later than July 2, 2004.

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For additional information, please call Doug Lacy-Roberts at (360) 902-0507 or Jane Johnson at (360) 902-0508.
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Off-site Examination Survey

(Use attachments as necessary)

Credit Union______________________ Contact Person & Phone #________________________

1. Measuring Interest Rate Risk (IRR)

a. What methods or model does your credit union use to measure IRR? Is it in-house or outsourced? If outsourced please provide the name of your vendor.

b. What IRR measurements does your credit union use? (i.e., NEV, NII, gap, etc.)

c. What are your Board approved policy IRR limits?

d. Who is the primary operator of your IRR system or model (name and title)?

e. Describe the training the operators have been provided on your system or model?

f. What were the results of your most recent model or IRR evaluation?

g. Is your model used for testing various product (loans and shares) pricing options before implementing the option? Please explain.

2. Asset / Liability Committee (ALCO) Structure

a. Does your credit union have a Board-appointed ALCO?

b. By position, who sits on the committee and what background do they have in managing IRR?

c. How often does your ALCO meet and report its decisions and discussions to the Board?

d. Please explain how the ALCO's work is periodically audited or the IRR model output verified.

Please Fax to our toll-free fax at (877-330-6870)