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Creating Cooperative Power

August 17, 2022

Hon. Todd M. Harper, Chairman
Hon. Kyle S. Hauptman, Vice Chairman
Hon. Rodney E. Hood, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA. 22314–3428

RE: NCUA Interest Rate Risk (IRR) Supervision and the Net Economic Value (NEV) Supervisory Test

To the Honorable Members of the NCUA Board:

The Cooperative Credit Union Association, Inc. ("Association") appreciates the opportunity to bring to your attention our member credit unions' concerns about the unintended consequences of the agency's Interest Rate Risk (IRR) Net Economic Value (NEV) Supervisory Test. The Association is the state trade association representing approximately 200 state and federally chartered credit unions located in the states of Delaware, Massachusetts, New Hampshire, and Rhode Island, which further serve over 3.6 million consumer members. The Association has developed these comments in consultation with our member credit unions.

The Association's High-Level Comments

- The Association urges the Board to revise the NCUA's approach to credit union IRR supervision by: (1) allowing credit unions that establish their own IRR models to opt-out of the one-size-fits-all NEV Supervisory Test; and (2) replacing the NEV Supervisory test with a dynamic standardized IRR management analysis that is more consistent with the Basel Committee on Banking Supervision's standardized IRR supervisory approach.

- "De-Risking" plans required to resolve the overly negative findings of NEV Supervisory Tests are causing well-managed credit unions to have to decapitalize themselves now to avoid the perceived threat of possible future decapitalization that may never occur.

- FFIEC guidance allows institutions to use their own NEV and other IRR models. The NEV Supervisory Test also uses a one-size-fits-all +300-basis point interest-rate shock even though the Basel Committee's IRR standardized approach updated in 2019 limits parallel interest rate shocks to 200 basis points and non-parallel interest-rate shocks to 300 basis points for short-term rates and 150 basis points for long-term rates.

<u>The Association's Detailed Comments</u>

The Association urges the NCUA Board to update its IRR guidance by: (1) allowing credit unions to opt-out of the NEV Supervisory Test if they establish IRR risk-management models consistent with Federal Financial Institutions Examination Committee (FFIEC) guidance on IRR; and (2) replace the NEV Supervisory Test with a dynamic standardized IRR approach that is more consistent with Basel Committee international standards. Action must be taken now to avoid unintended consequences resulting from the inflexible application of a well-intentioned but one-size-fits-all supervisory tool that is unfortunately not well calibrated.

Without updates to the agency's IRR policy, many well-capitalized credit unions that have robust IRR management strategies risk being placed in the NEV Supervisory Test's "Extreme Risk" category—which is considered categorically unsafe and unsound—and having their CAMELS ratings downgraded even though they are well-prepared to deal with IRR in a rising rate environment. The "Extreme Risk" definition should be narrowed because it captures too many credit unions that are <u>not</u> extremely risky as an objective matter. Credit unions should also be able to rebut any presumption that they are at an IRR "Extreme Risk."

Credit unions report that NCUA typically requires institutions to correct an "Extreme Risk" situation within 12-18 months, often leading to sales of fixed-rate assets at a loss compared to their return had they been held to maturity, as well as balance sheet shrinkages. These are both very expensive strategies that lock-in losses of Net Worth that also result in the credit union having lower levels of net income, which hinders credit unions' ability to build additional capital through earnings retention.

Other, better approaches to reducing a credit union's IRR profile include strategies that allow greater earnings retention to build Net Worth, such as cash-flow redeployment and controlled asset growth, as well as interest-rate swaps and caps that can be used to turn a fixed-rate position into a variable-rate position. Yet even these strategies hinder CU's ability to grow, earn, and better serve their communities, just to a lesser extent that the quicker solutions mentioned above.

The NEV Supervisory Test's premium assumptions are flawed and place undue stress on NEV calculations' funding valuations because:

- <u>Premiums are One-Size-Fits-All</u>: The same Non-Maturity Share (NMS) premiums are used for all credit unions in the United States even though the actual composition of a credit union's NMS can vary significantly from credit-union-to-credit-union.

- <u>Premiums are "Fixed" Even After Rates Increase</u>: The premium assumptions remain fixed even after rates increase—they remain the same 1% for the 0-Shock scenario and the same incremental 4% for the Shock +300 basis points scenario even after the recent increases in interest rates—which means the implied additional value NMS should receive as rates rise are never realized.

- <u>Premiums Assume Unrealistic Average Lives on NMS:</u> Credit union NMS are sticky and stable, but the NEV Supervisory Test assumes a much higher run-off rate than is reasonable, assuming average lives of 6-18 months. Basel Committee international standards, in contrast, assume that 90 percent of retail NMS will remain with an institution perpetually even in a stress scenario.[1]

We urge the NCUA Board to allow credit unions to use their own IRR models in a manner consistent with the FFIEC's *Advisory on Interest Rate Risk Management* (2010)[2] and *Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions* (2012)[3] instead of being required to use the one-size-fits-all NEV Supervisory Test.

To the extent that the agency chooses to retain a standardized NEV modeling approach for at least some credit unions, we urge the Board to look to the Basel Committee's *Interest Rate Risk in the Banking Book* IRR standardized supervisory approach.[4] Instead of using a blanket +300 basis point interest rate shock scenario like the NEV Supervisory Test, the Basel Committee's more dynamic standardized approach to IRR modeling updated in 2019 limits parallel interest rate shocks (in US-Dollar economies) to 200 basis points and non-parallel interest-rate shocks to 300 basis points for short-term rates and 150 basis points for long-term rates shocks.[5]

We urge the Board to act swiftly to update the agency's approach to IRR management by:

(1) allowing credit unions to establish their own IRR models and opt-out of the NEV Supervisory Test; and

(2) replacing the NEV Supervisory test with a dynamic standardized IRR supervisory analysis that is more consistent with Basel Committee standards.

The Association appreciates the opportunity to bring our members' concerns about the NEV Supervisory Test to the NCUA Board's attention. If you have any questions about our comments or require further information, please do not hesitate to contact the Association at govaff-reg@ccua.org.

Sincerely,

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[1] Basel Committee on Banking Supervision, *Net Stable Funding Ratio*, ¶ 30.12 (2019), *available at* https://www.bis.org/basel_framework/standard/NSF.htm.
[2] https://www.ffiec.gov/pdf/pr010710.pdf.
[3] https://www.ffiec.gov/PDF/01-12RR_FAQs.pdf
[4] Basel Committee on Banking Supervision, *Interest Rate Risk in the Banking Book* (2019), *available at* https://www.bis.org/basel_framework/chapter/SRP/31.htm?inforce=20191215&published=20191215
[5] *Id.* at ¶ 31.90.