c. myers

May 16, 2011

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comments on Proposed Rulemaking for Part 741

Dear Ms. Rupp:

Thank you for the opportunity to respond to the Advanced Notice of Proposed Rulemaking for Part 741.

C. myers agrees with the objective that most institutions should have an effective interest rate risk (IRR) management policy supported by an effective IRR program.

However, we do not agree that it should be regulation.

If you have any questions or would like to discuss the following commentary in further detail, please don't hesitate to contact us at 800.238.7475.

Sincerely,

Sally Myers
CEO

John Myers
President

Rob Johnson
EVP

Pete Crusius
SVP

Adam Johnson
SVP

c. myers corporation • pointe south mountain corporate centre
8222 south 48th street • suite 275 • phoenix, arizona 85044 • 800.238.7475 • fax 602.840.7909 • www.cmyers.com

Overview

Keep in mind as you read our comments that our business is to provide asset/liability management services to financial institutions. We have worked with hundreds of credit unions providing long-term risks to earnings and net worth simulations, static and dynamic balance sheet analyses and net economic value (NEV) simulations.

A regulation of this nature would likely materially increase our business opportunities, yet we do not believe it is in the best, long-term interest of the industry.

One primary reason that we do not support the proposed regulation is that it is ambiguous. We understand this ambiguity is necessary. However, ambiguity will lead to subjectivity when implementing the regulation. **Whether a credit union has a written policy with adequate limits and an effective program addressing IRR may ultimately be determined by each credit union's *most recent* examiner.**

The implementation of this regulation will likely lead to one or more of the following: confusion, application of generic standards to unique situations, false sense of security or credit unions spending more time, energy and money on analyses that don't necessarily provide boards, managements and regulatory authorities with relevant or reliable decision information.

Key Questions

Before such a regulation is passed, NCUA should minimally answer the following questions clearly:

- By implementing a regulation on IRR management, what power will NCUA gain that they don't currently have?
- How will NCUA change their approach in the exam process if this regulation is implemented? If NCUA says they will not change their approach, then why is there a proposal for regulation?
- Who will ultimately determine if a credit union's policy limits are adequate and programs are effective? If it is the most recent examiner, what happens when the next examiner, a year later, has a different opinion about the adequacy of the policy and effectiveness of the program? There are many good examiners in the field, but there are already some who are using this proposed regulation as a checklist to dictate policy changes.
- If a credit union is outside of policy, will it be deemed "**out of compliance"?** If so, what are the consequences for the credit union? What recourse will the credit union have if it does not agree with the examiner's assessment that the credit union is "**out of compliance"?**

If the regulation is passed, the guidance in the Appendix does not address a key question, which is, "What is the net worth ratio ***not at risk*** if a material and sustained change in interest rates occurs?" While NEV is noted often in the proposal, **NEV and net worth[1] are not the same.**

We agree that IRR is materially increasing in many credit unions and we are concerned with this trend. However, there are many contributing factors to this issue that a regulation, no matter how well intended,

[1] Net worth as defined by NCUA in 702.2 (f) is *the retained earnings balance of the credit union...* Note: retained earnings change as a result of positive or negative net income. NEV does not indicate positive or negative net income.

will not change. As a matter of fact, the regulation could have the exact opposite effect. Contributing factors include:

- Continuation of relatively high provision expense for many credit unions. This is lowering current earnings and causing some decision makers to try to compensate by reaching for yield.
- Consumers restructuring their personal balance sheets resulting in low loan demand. This is also lowering current earnings causing some decision makers to reach for yield.
- Conflicting messages from examiners.
- Increasing threats to revenue, such as the threat of declining interchange income.

If these conditions continue, or these threats become reality, it could increase risk taking beyond IRR unless outdated measures of success in our industry are altered.

Change In Mindset Is Needed—Not A New Regulation

One key thing that needs to change is the mindset of boards, managements and regulatory authorities. Continued reliance on traditional measures of success in this environment has resulted in more risk taking.

For example, asset growth is often viewed as a critical measure of success even if there is no corresponding, quality loan growth. We saw what growth for growth's sake did to select, large corporate credit unions. Most credit union business models rely on loans increasing. However, in today's environment, many are seeing their loan balances decline. If decision makers believe this trend will be long term, they will need to shift their mindset and business models to have less reliance on loans—which could mean less asset growth. As such, the traditional definition of success would need to change.

Another is the notion that the higher the current ROA (and the higher the margin), the better. This is especially dangerous as the cost of funds for many is nearing the floor while the yield on assets generally continues to decline or experience downward pressure. This is one of the potentially conflicting messages from NCUA as examiners push for better margins and earnings right now. Focusing on the margin today can invite an increase in IRR and/or credit risk.

What Is The Definition Of Effective?

Interest rate risk quantification and management are complex processes with many interrelated components that, when combined with the unpredictability of human behavior, increase the subjectivity of the definition of "effective." What is effective for one group or credit union may not be effective for another group or credit union. Such differences need to be taken into account when defining "effective."

Establishing written policies is prudent business management in any industry. Equally important is making strategic and business decisions using policy as guidance. However, there are times that organizations will be outside of established limits for sound reasons or due to unforeseen external forces that impact the credit union, yet have nothing to do with the management's or board's decision making. Those reasons need to be adequately articulated and a plan of action, or inaction, should be documented. This is where understanding the uniqueness of the individual business is critical.

Unintended Consequences—One-Size-Fits-All

As stated in the proposed regulation, *IRR management involves judgment by a FICU based on its own individual mission, structure, and circumstances. Any rule must take into account the diversity of FICUs and avoid a one-size-fits-all approach. Accordingly, FICUs should devise a policy and risk management program appropriate to their own situation* (Federal Register, Page 16571).

While this is a worthy objective, we believe that, in reality, if this proposed regulation passes, the industry will face a number of unintended consequences.

One unintended consequence is that the industry evolves to a one-size-fits-all approach. Examiners will want guidance, likely in the form of a checklist from NCUA in D.C., as to what appropriate policy limits look like as well as an effective IRR management program. As an examiner is faced with the pressure of making sure an institution is **"in compliance,"** they may want to cover themselves by asking for everything on the list, resulting in significant expense to credit unions—often without benefit or relevance to the credit union's unique structure. It is interesting to us that, since this proposed regulation came out, we have received more calls from "complex" clients saying examiners are requesting gap analysis than we have had in the last 5 years. We are convinced that these requests for gap analysis are an unintended consequence of some of the wording in the proposed regulation.

The guidance will then inadvertently become the rule, resulting in a one-size-fits-all approach. If this occurs, NCUA carries the burden of giving appropriate guidance to the field examiners such that the guidance does not gravely impact the safety and soundness of the industry.

Our definition of safety and soundness includes the fact that credit unions must have the ability to compete and remain relevant to their target markets in the long term. If risk limits and quantification of risk become one-size-fits-all, it can become more difficult for credit unions to differentiate—which can negatively impact their ability to compete.

The Desire For Comparability Will Likely Lead To Simplifying Assumptions.

In an effort to determine if a credit union has an adequate policy and/or IRR program, field examiners will likely increase their reliance on "peer" data. We believe reliance on peer data is a major contributing factor to the struggles the industry is facing. Pressure to "keep up with the Joneses" led some credit unions to take risks they did not have the capacity to manage.

It is likely that the ability to compare simulation results credit union to credit union will become more important for the field examiners. This will likely lead to each credit union having to use a standard set of assumptions so that it is easy for field examiners to compare credit union to credit union. Oftentimes, these assumptions used for comparability are simplifying assumptions.

In some cases, we see this happen today and there is no regulation. Imagine how pervasive it would become if a field examiner had to determine if a credit union was **"in compliance"** with regulation.

A couple examples of simplifying assumptions used today include:

- Static balance sheet analysis—This analysis assumes that the composition of the balance sheet never changes, even if rates change. In this type of analysis, decision makers are forced to assume that, as rates go up, the distribution of deposits will remain exactly as it is today. In a risk simulation, it does not make any sense to assume that deposits have no rate sensitivity as rates go up. This can lead to a false sense of security regarding risks to earnings and net worth. This view also conflicts with the

comment in the proposed regulation that states: …*nonmaturity share balances vary at the discretion of the depositor making deposits and withdrawals, and this may be influenced by a credit union's pricing of its share accounts* (Federal Register, Page 16574).

The above is just one example of why the simplifying assumptions required for static balance sheet analysis and comparability are not prudent. For more information, please refer to our recently published article, Things To Consider When Evaluating Static Simulations.

- Non-maturity deposits at par in NEV simulations—Examiners will often tell us they like this view because it isolates changes in balance sheet structure simulation-to-simulation. This is not true. If a credit union shifted from having 30% of assets in regular shares and 20% in money markets to 10% in regular shares and 40% in money markets, NEV simulations assuming non-maturity shares at par would not disclose this shift. Such a shift could have a material impact on the safety and soundness of the credit union.

    - Non-maturity shares at par will also not disclose risks to earnings and therefore cannot disclose risks to net worth. Consider the following:

      NEV simulations assuming non-maturity deposits at par ignore the credit union's pricing strategy. In this view, it would not matter if a credit union paid 20 basis points (bps) or 200bps on regular shares or if a credit union paid 50bps or 500bps on money markets. It would also not matter if checking accounts pay zero interest or if rewards checking accounts pay 300bps.

      The following statement in the proposed regulation is contradictory to using a non-maturity deposits at par approach: *By capturing the impact of interest rate changes on the value of all future cash flows, NEV provides a* ***comprehensive measurement*** (emphasis ours) *of IRR* (Federal Register, Page 16575). Shares at par contradicts this statement, yet, as noted earlier, field examiners often request this view when evaluating NEV simulations.

There are many more examples of simplifying assumptions that are often recommended by examiners to make comparability easier. We believe this approach will be pervasive if this regulation is passed, which would likely lead to the unintended consequence of a one-size-fits-all approach.

It is critical to mention that the use of these types of simplifying assumptions never really address the credit union's unique level of risks to earnings and net worth, risking the credit union decision makers and regulators being blindsided. Avoiding this risk should be a primary driver in the risk management process.

Appropriate Policy Limits

Another concern is the evaluation of appropriate policy limits to ensure **"compliance"** with the regulation. The proposed regulation states:

- *Set risk limits for IRR exposures based on selected measures (e.g. limits for* ***changes*** (emphasis ours) *in repricing or duration gaps, income simulation, asset valuation, or net economic value);* (Federal Register, Page 16575).

While NCUA has stated in the proposed regulation that these examples of the types of limits to set and how to set them, the concern is that these examples will become the rule.

Our question is: Why the focus on percent change versus focusing on the actual risk?
If a line in the sand is never drawn, then as long as a credit union continues to be within the percent change they identified, it would be acceptable for their risk profile to continue to deteriorate. Also, these types of limits don't address whether the credit union has an adequate net worth ratio.

Consider the following example if the guidance NCUA provides to examiners regarding this proposed regulation is similar to that in the below excerpt from the IRR Questionnaire (Table A):

Table A

	---------- RISK ----------		
Basis of Measurement	**LOW**	**MODERATE**	**HIGH**
Earnings Simulation			
(NI)			
after shock change over any 12 month period	<40%	**40--75%**	>75%
NEV			
after shock change in market value net worth	<25%	**25--50%**	>50%
OR			
after shock value of net worth	>6%	**4--6%**	< 4%

If a credit union has a 1.00% ROA, to maintain a "moderate" level of risk to earnings, the ROA can't fall below 0.25% (maximum 75% decline) in a 300bp change. Whereas, a credit union with a 0.40% ROA can have their earnings drop to 0.10%. What if, at the time of the next simulation, the credit union with a 1.00% ROA is at 1.25%? Then their ROA can't fall below 0.31%. If the credit union that was earning 0.40% now earns 0.30%, then their earnings can't fall below 0.08%.

In essence, using the percent change methodology, if an institution's earnings increase in the future, the bar is raised. Conversely, if earnings drop in the future, the bar is lowered. Is this really a good measure of safety and soundness?

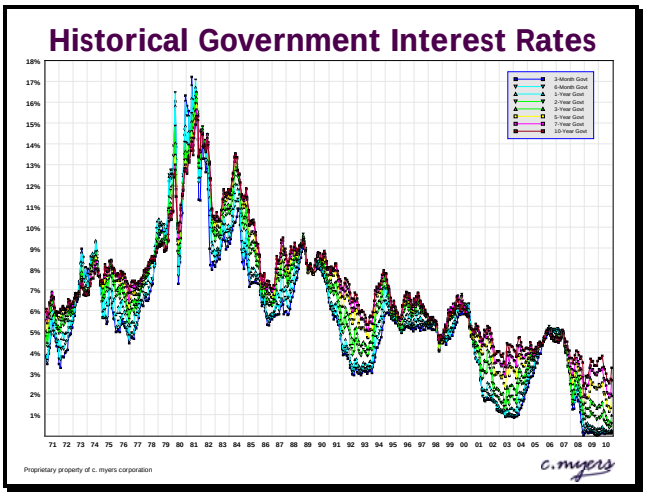
Additionally, a percent decline approach applied to earnings would never allow a credit union with positive earnings to make the business decision to allow for negative earnings. There are several cases where external forces or strategic plans make negative earnings in the short term a reality in order to balance the long-term viability of the organization.

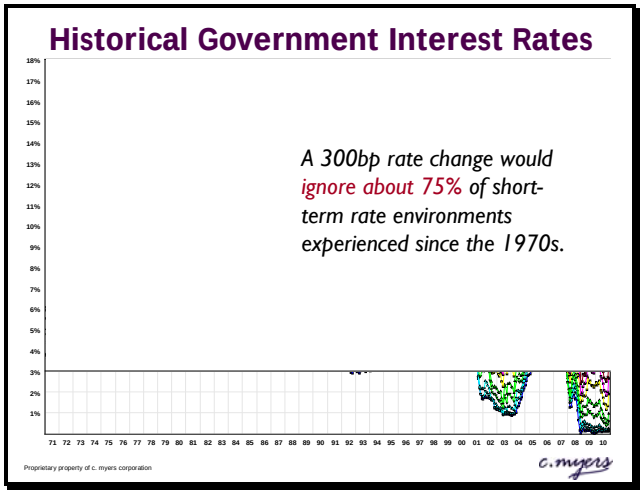
Using these guidelines would put any credit union with negative earnings out of policy. Does that mean that every credit union losing money would automatically be **"out of compliance"?** Note that, in 2010, approximately 40% of all credit unions had negative earnings after factoring additional NCUSIF expense. The potential ramification of this path could be detrimental to the industry.

Policies Will Likely Be Set At Minimum Guidance/"Standards"

Under the proposed regulation, we believe that policies would no longer be used to guide strategic and business decisions. Most boards and managements want to be **"in compliance."** Therefore, if this regulation is implemented, policies will likely be written to pass minimum "standards."

One of the minimum standards has been a 300bp change in rates, typically with no shift in the yield curve. Limiting the view to a 300bp rate change today would ignore about 75% of the short-term rate environments the U.S. financial markets have experienced since the 1970s.





If NCUA is trying to keep the same form of guidance provided in the IRR Questionnaire, then it is interesting that a risk to net worth limit is not included—especially since net worth classifications have been established by the Credit Union Membership Access Act (CUMAA). Again, we are concerned that the NEV ratio and net worth ratio are often used interchangeably in the industry. This should not happen as they are not the same thing.

If NCUA considers the change in NEV or the resulting NEV ratio to be the guidance on threats to net worth, why is it acceptable to indicate a credit union has moderate risk if rates move 300bps and the resulting NEV ratio (net worth ratio) is between 4% and 6%? (Refer to Table A.) If NEV were an indicator of net worth, why would the agency consider risk to be moderate if a credit union falls to the bottom of the Undercapitalized Classification? This can be particularly dangerous as NEV does not include the credit union's unique net operating expense structure, which does directly impact the net worth ratio.

Guidance Versus Requirements For Credit Unions Over $500M In Assets

Some examiners are currently telling credit unions that the proposed regulation will *require* credit unions over $500M in assets to perform NEV simulations and set policy limits based on NEV. If the regulation is intended to make NEV a requirement, then it needs to be made clear.

The proposed regulation states:
For example, the credit union ***should consider*** (emphasis ours) *the following:*

- *IRR measurements that provide compliance with policy limits as shown both by risks to earnings and net economic value of equity under a variety of defined and reasonable interest rate scenarios* (Federal Register, Page 16579)*;*

If conducting, and ultimately making, strategic and business decisions based on NEV simulations will be required by this regulation—then NCUA should change the phrase ***should consider*** to ***must do.***

We imagine that the intent of NCUA is to not require NEV as that would be in direct conflict with many components of the proposed regulation, such as: *IRR management involves judgment by a FICU based on its own individual mission, structure, and circumstances. Any rule must take into account the diversity of FICUs and avoid a one-size-fits-all approach. Accordingly, FICUs should devise a policy and risk management program appropriate to their own situation* (Federal Register, Page 16571).

Summary

We believe the objectives of several of the issues outlined in the proposed regulation are worthy. However, because of the subjectivity, we believe the regulation, if implemented, will lead to undesirable, unintended consequences. We recommend that NCUA not pursue a regulation for IRR policies and programs. We also recommend that NCUA evaluate how the questions they are currently asking regarding IRR policies and management need to change to address key issues regarding safety and soundness.