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May 5, 2011

Ms. Mary Rupp
NCUA, Secretary of the Board
1775 Duke Street
Alexandria, VA 22314-3428

Dear Secretary Rupp:

I am writing in response to the recent draft regarding interest rate risk and requiring FICUs to have an interest rate risk policy. We certainly agree that having such a policy is an appropriate requirement. The purpose of this letter is to comment on several aspects of the draft regulation and call attention to several issues that were either not addressed or that require clarification. Some of these are minor items and some are not.

1. ***Outside Providers.*** The draft refers to the use of outside providers of interest rate risk (or ALM) assessments. These are usually second opinions or outsourced analyses. As correctly pointed out in the draft, it is inadequate if management cannot explain the measurement procedure or the results. But there is another problem that is not mentioned—the inherent conflict of interest that arises when the provider sells investments or, as in the case of a conserved corporate credit union, derivative products presumably to hedge the risk they are measuring. We have seen recommendations from such providers that the “risk” can be mitigated or income enhanced by the products sold by the outside provider. This is a potential conflict of interest.
2. ***Treasury or LIBOR Yield Curve.*** The draft indicates that CUs with significant risk exposure resulting from embedded options “should consider” discounting using a yield curve such as the Treasury or LIBOR curve. The recent experience from our clients getting an outside second opinion ALM analysis using this approach raised many questions regarding this suggested procedure. This approach can raise more questions than answers for a host of reasons.

The Treasury yield curve can be highly volatile due to “safe haven” buying during a crisis which is an increasingly common event. During such crises other market rates are far more stable which indicates that risk spreads widen and contract very quickly. Another serious problem with this approach is that the underlying cash flows in CUs are not riskless from a credit standpoint and they differ in each balance sheet category so at each point on the yield curve (360 months?) a risk premium must be added to the corresponding Treasury rate. To further complicate this problem, it is normal for the risk premium spreads to change across the maturity spectrum. Thus, the question arises—where does one find this information for their particular products and is it disclosed and verifiable? To our knowledge there is no verifiable source of such information and disclosure is never provided.

The use of LIBOR has similar risk premium issues but the procedure has additional serious problems that are unique to this index. First, this curve goes out only 12 months. Furthermore, in contrast to the safe haven effects in the Treasury market, the LIBOR yield curve is subject to the opposite effect—fear of default by banks. In mid-2008 the 3-month LIBOR, for example, was about 2.75%. However, as panic set in when Lehman failed T-bill rates decreased due to safe haven buying but LIBOR increased to about 4.75% as banks were afraid to lend to one another. (It has subsequently declined to 27BPs.) Again, offering rates in the financial institution

sector for loans and deposits changed considerably less than the LIBOR rates thus indicating that spreads changed dramatically. It might be argued that this blow-up was an unusual, one-time, crisis-related event. Perhaps this is true. But as pointed out recently in *The Wall Street Journal*, the banks that combine to set the LIBOR rates are now under investigation by the SEC, DOJ, the Commodities Futures Trading Commission and several countries for possible manipulation of the LIBOR rates.

To summarize, both the Treasury and LIBOR yield curves can be subject to outside influences that have little or no bearing on FICU operations. The key question here is how valid are discount rates derived from this procedure even if appropriate and transparent risk premiums can somehow be obtained? Furthermore, these rates are extremely volatile as we witnessed during the financial crisis in 2008.

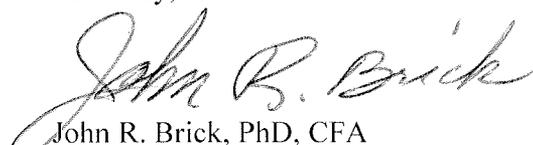
The experience of one of our clients getting a second opinion ALM analysis using this procedure was enlightening, to say the least. The client asked us to review and explain the second opinion ALM report to them since no interpretation was available from the party that produced the analysis. When we raised questions about the current and shocked discount rates that we knew were determined using the procedure described above, he could not answer our straight-forward questions. We suggested that he contact the ALM provider and get the yield curve with the risk spreads and if possible, the single internal rates of return that would equate the present value and the discounted value for his loans, especially his mortgage loans since those market rates are readily observable. This rate would be quite useful to determine if the yield curve procedure produced results that made sense by being reasonably close to prevailing market rates. After about a week he was told by the second opinion ALM provider that they could not produce the numbers he requested because they were “black box” numbers. That is, they were produced by the ALM system and apparently they could not be determined or verified.

I bring this to your attention because on page 37 under IRR Oversight & Management it was deemed inadequate if “assumptions are not. . .transparent to those evaluating efficacy of the IRR system.” Thus, it is not only a practical implementation problem, it is a transparency issue, unless of course, one has blind faith in “black box” numbers.

3. ***Putable (or Convertible Borrowings).*** The paper references a number of sources of interest rate risk such as mortgage loans, CMOs and other complex investments. However, risk-increasing complexity can also be found on the liability side in the form of putable (or convertible) borrowings. There is no mention of these in the draft. Recent regulatory action involving a large east coast thrift (Hudson Bancorp) highlighted this issue.
4. ***Gap Analysis.*** The draft suggests that this approach may be appropriate for simple balance sheets. However, even for these institutions this approach provides little useful information since it does not deal with basis risk even in simple balance sheets. Furthermore, these smaller institutions usually have a large comingled share account containing both rate sensitive and non rate sensitive funds. This makes the risk assessment far more difficult especially when using gap analysis. Since few institutions use this procedure anyway, it may be time to put it to rest.

On balance the proposed rule is reasonable and codifies what is already the widespread and acceptable practice of having a written ALM/Interest Rate Risk Management Policy. We hope our comments are helpful in formulating the final rule.

Sincerely,



John R. Brick, PhD, CFA
President