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Via e-mail to regcomments@ncua.gov.

May18, 2011

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

Re: Comments on Part 741 - An Effective Interest Rate Risk (IRR) Program

While it is generally true that over the past ten years many credit unions have increased their exposures to IRR by holding larger asset mixes of both long-term real estate loans and complex investments at paces that have exceeded their net worth growth rates, it also holds that many other credit unions (regardless of size) have not. It is also generally true that larger credit unions (specifically credit unions over \$100 million in assets) have been more prone to engage in IRR-taking activities than smaller credit unions. However, it is impossible to access a credit union's IRR solely by its asset size.

Comment #1: The proposed rule uses an IRR exposure ratio (IRRXR) to quantify a FICU's IRR relative to its net worth. In the proposed rule, the IRRXR is calculated as the sum of first mortgage loans held plus total investments with maturities greater than five years divided by net worth. While a metric of this nature can be used to broadly gauge a FICU's IRR, the numerator of the IRRXR in the proposed rule is not inclusive of several assets that can possess considerable IRR.

The Asset Pricing Table in the appendix ranks several types of loans and investments according to their levels of IRR. The IRR of interest-earning assets (or term liabilities such as a term share CDs, borrowings, or nonmember deposits) can be classified by their +300 basis point (bp) price volatilities (V) according to the following criteria.

- Very low IRR if V is less than -3%.
- Low IRR if V is in the -3% to less than -9% range.
- Moderate IRR if V is in the -9% to less than -15% range.
- High IRR if V is -15% or greater.

Not all first mortgage loans have high IRR. As the Asset Pricing Table indicates, one year and 3/1 ARM's have low +300 bp price volatilities. Likewise, certain types of non-first mortgage loans (for example, 15-year fixed-rate home equity loans) have high +300 bp price volatilities. Yet the proposed rule's IRRXR includes all first mortgage loans and it excludes all types of non-first mortgage loans. The proposed rule's IRRXR not only omits investments with embedded options, but it only includes investment with maturities greater than five years, thereby neglecting bullet investments with maturities between three and five years that possess moderate IRR. Also the proposed rule's IRRXR would classify a variable-rate investment having a maturity greater than five years as a high IRR investment, even if it had a quarterly rate reset frequency and a rate cap 400 bp to 500 bp out. **To correct these errors and omissions, the numerator of the proposed rule's IRRXR should be changed to include the sum of all long-term RE loans (that can be determined from**

data currently reported on Form 5300) that will refinance, reprice, or mature in more than five years plus complex investments (both securities and non-securities) as they are currently defined in Parts 703.10(a) and 703.12(b).

Comment #2: Exclude FICUs with assets under \$20 million and any FICU having assets \$20 million or over and less than or equal to \$100 million with an IRRXR (as calculated in accordance with the recommendation put forth in Comment #1) less than 150% from the requirements of proposed Part 741.3(b)(5)(i).

The proposed rule would currently exclude FICUs with assets under \$10 million and any FICU having assets \$10 million or over and less than or equal to \$50 million with an IRRXR (as defined in the proposed rule) less than 100% from the requirements of proposed Part 741.3(b)(5)(i).

Using three asset groupings from the proposed rule and the ratio of the sum of long-term RE loans (RE loans that will refinance, reprice, or mature in more than five years as determined from Form 5300 data) and total investments having rate resets or weighted-average lives (WALs) greater than three years to net worth as a proxy for the IRRXR that was recommended in Comment #1, the table below depicts each group's dollar weighted-average IRRXR based on 12/31/10 data. (Note that the exact amount of complex investments for each group could not be determined since FISCUs don't report Part 703.10(a) non-securities and Part 703.12(b) securities on Form 5300).

Total Assets	IRRXR	FICUs	IRR Level
Under \$10mm	52%	2777	Very Low
\$10-\$50mm	148%	2395	Moderate
Over \$50mm	309%	2163	High
All FICUs	292%	7335	High

The above table reveals both that larger FICUs generally have higher IRR than do smaller FICUs and that the asset groupings used in the proposed rule reasonably identifies IRR between the groups.

The asset groupings were further stratified in the second table in order to better examine IRR differences of FICUs with assets between \$20 million and \$100 million.

Total Assets	IRRXR	FICUs	IRR Level
Under \$10mm	52%	2777	Very Low
\$10-\$20mm	105%	1083	Low
\$20-\$50mm	166%	1312	Moderate
\$50-\$100mm	209%	794	Moderate
Over \$100mm	317%	1369	High
All FICUs	292%	7335	High

This table makes it clear that FICUs in the first two groups (i.e., assets under \$20 million) have little IRR and that the difference in the two groups' IRR is not significant. However, IRR increases more noticeably into the moderate to high levels as the asset groupings move to bigger asset ranges. The asset group of FICUs over \$100 million has a considerable level of IRR and their IRR dominates the aggregate IRR of all FICUs.

FICUs were further clustered into three asset groups in the third table such that each group's IRR profile could be irrefutably classified as low IRR, moderate IRR, or high IRR. It is evident from this asset grouping that FICUs under \$20 million are a low IRR group, which results from their less complex balance sheets and their higher capitalization than FICUs in the two higher asset groups. It is also apparent that FICUs in the \$20 to \$100 million group have notably more IRR than FICUs under \$20 million, but significantly less IRR

than FICUs in the greater than \$100 million group. Therefore, these three asset groups are advised in the proposed rule.

Advised Asset Groups

<u>Total Assets</u>	<u>IRRXR</u>	<u>FICUs</u>	<u>IRR Level</u>
Under \$20mm	82%	3860	Low
\$20-\$100mm	182%	2106	Moderate
Over \$100mm	317%	1369	High

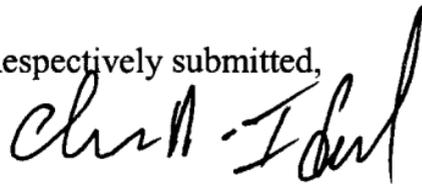
Additionally, from my 20 plus years of researching and analyzing credit union net economic value (NEV) volatility (i.e., the long-term IRR embedded in a credit union's balance sheets relative to the adequacy of its net worth to support that level of IRR), it has been my experience that a credit union typically does not have a high level of +300 bp NEV volatility that starts to approach or exceed -50% or a +300 bp net worth ratio either near or below 4% until its IRRXR exceeds 200%, so a **150% IRRXR hurdle for FICUs having assets \$20 million or over and less than or equal to \$100 million is advised in determining whether they must comply with the requirements of proposed Part 741.3 (b)(5)(i). FICUs having assets greater than \$100 million should comply with the requirements of proposed Part 741.3(b)(5)(i).** However, all credit unions (regardless of size) should be encouraged to have in place an effective IRR management program that measures, monitors, and controls IRR that is commensurate with the ALM complexity of their balance sheets and net worth levels.

Other Comments: Appendix B to Part 741

1. Section II mandates that the frequency with which management will report IRR measurement to the board will be at least quarterly. Unless a FICU is actively pursuing activities that could significantly change its IRR profile, a longer frequency, such as semiannual, may be appropriate provided that the FICU has a low level of IRR, a non-complex balance sheet, and adequate capitalization. Further, a FICU's IRR profile will not change very much from one time period to the next unless it is pursuing activities or it is exposed to events that could rapidly change its IRR profile. However, if a FICU's IRR profile is changing rapidly (regardless of reason), then monthly IRR testing may be appropriate. **Replace the "at least quarterly" IRR testing requirement with an "at least semiannual" testing requirement in Appendix B.**
2. In Section II, the references to GAP and income simulation are vague. GAP ratios should be cumulative over the next six-month time span, not one year. Since cumulative GAP ratios approach zero percent the longer the time span, one year is too long to detect spread's vulnerability to volatility in interest rate levels over the short term (such as during the next six months). However, if income simulation is used instead of GAP to measure short-term IRR exposure, it should be done on a one-year forward basis. Further, cumulative six-month GAP to total asset ratios that exceed -35% for +100 bp rate shocks and +35% for -100 bp rate shocks imply a relatively high level of short-term risk to net interest income, spread, and operating ROA.
3. Section IV (C)(4)(Example 4) mentions that one reason for valuing of nonmaturity share accounts (NMSAs) at book in NEV analysis is that it is simple, whereas valuing NMSAs at market requires a present value pricing model, accurate (and consistently applied) dividend rate assumptions, and appropriate (and often disputable) discount rate assumptions. There are more substantial reasons than simplicity for valuing NMSAs at book. Foremost are the accuracy and consistency of the dividend rate assumptions from one time span to another when market values for NMSAs are used. Small changes in dividend rate assumptions can result in wide variations in NMSAs' fair values in +/- 300 bp shock scenarios, thereby vastly affecting NEV volatility and overshadowing the impact that asset

duration (the key underlying factor that determines IRR in a credit union's balance sheet) has on NEV volatility. Further, NMSAs' base-case scenario fair values tend to be understated in high-rate environments, resulting in overstated base NEVs which can result in significantly understated +/- 300 bp NEV volatility. This explains why credit unions that value NMSAs at market are experiencing much higher NEV volatility in the current low-rate environment than they did in high-rate environments several years back even through there have been no significant changes in their asset durations or book net worth ratios. All of these problems and distortions can be eliminated if NMSAs are valued at book. **In an NEV analysis, term liabilities such as borrowings, uninsured secondary capital accounts, share certificates, and nonmember deposits should be valued at market, but NMSAs should be valued at book.**

Respectively submitted,

A handwritten signature in black ink that reads "Charles R. Idol". The signature is written in a cursive, flowing style.

Charles R. Idol, Ph.D.

Appendix		Asset Pricing Table						Compiled by Charles R.Idol		
Asset Type	WAM or Next Repricing Date (mo)	Amortization (mo)	Weighted-Average Coupon (WAC)	+300bp Prepayment Speed	Base Market Price	+300bp Market Price	+300bp Price Volatility	+300bp Effective Duration	+300bp WAL (yr)	
1 yr. ARM	12	360	3.00%	7% CPR	100.00	97.67	-2.3%	-0.8%	0.9	
1 yr. Bullet Investment	12	Bullet	1.00%	Bullet	100.00	97.09	-2.9%	-1.0%	1.0	
48 mo. Auto Loan	48	48	3.50%	1% ABS	100.00	95.54	-4.5%	-1.5%	1.6	
60 mo. Auto Loan	60	60	3.75%	1% ABS	100.00	94.86	-5.1%	-1.7%	1.9	
72 mo. Auto Loan	72	72	4.00%	1% ABS	100.00	94.30	-5.7%	-1.9%	2.1	
84 mo. Auto Loan	84	84	4.25%	1% ABS	100.00	93.83	-6.2%	-2.1%	2.3	
3/1 yr. ARM	36	360	3.75%	7% CPR	100.00	92.39	-7.6%	-2.5%	2.8	
3 yr. Bullet Investment	36	Bullet	2.00%	Bullet	100.00	91.74	-8.3%	-2.8%	3.0	
Very Low to Low Rate Risk (Effective Duration) Assets										

Moderate to High Rate Risk (Effective Duration) Assets									
10 yr. Fixed Home Equity Loan	120	120	6.00%	7% CPR	100.00	89.19	-10.8%	-3.6%	4.7
5/1 yr. ARM	60	360	4.00%	7% CPR	100.00	88.96	-11.0%	-3.7%	4.6
5 yr. Bullet Investment	60	Bullet	3.00%	Bullet	100.00	87.20	-12.8%	-4.3%	5.0
4 yr. Agency PAC CMO	4 yr. WAL	360	3.50%	7% CPR	100.00	87.00	-13.0%	-4.3%	4.0
7/1 yr. ARM	84	360	4.50%	7% CPR	100.00	86.62	-13.4%	-4.5%	6.3
15 yr. Fixed Home Equity Loan	180	180	6.50%	7% CPR	100.00	86.50	-13.5%	-4.5%	6.6
15 yr. Fixed 1st RE Loan	180	180	4.50%	7% CPR	100.00	85.88	-14.1%	-4.7%	6.4
30 yr. Fixed 1st RE Loan	360	360	5.00%	7% CPR	100.00	81.57	-18.4%	-6.1%	10.3
10 yr. Bullet Investment	120	Bullet	4.00%	Bullet	100.00	78.68	-21.3%	-7.1%	10.0