



May 20, 2011

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

Dear Ms. Rupp:

On behalf of the partners of ALM First and its management staff, I am writing in response to the draft proposal for addressing requirements for a written policy on interest rate risk (IRR) and effective IRR management. I thank you for this opportunity.

The proposal on managing interest rate risk requires credit unions to have a written policy that expressly states the credit union's IRR tolerance and to adopt an effective IRR program that "identifies, measures, monitors and controls IRR".

In general, we believe that providing IRR assessments of new business and using IRR measurements more frequently in decision making are both good ideas. The Office of Thrift Supervision (OTS) has required this of Thrifts for years. We do believe, however, that one goal of the NCUA should be the education of its examiners in order to ensure the accuracy of these assessments. Examiners should understand that suggested guidelines are just that and credit unions that adequately defend their IRR strategy with reasonable and prudent guidelines outside of those suggested, is not necessarily a bad thing. If assumptions and guidelines are deemed to be reasonable, imposing additional tests just to compare to the norm may not be meaningful, especially in cases where a validation is also required.

APPENDIX B to Part 741 – Guidance for an Interest Rate Risk Policy and an Effective Program

IV. IRR Measurement and Monitoring

Too many ALM Risk Measurements

In its guidelines for ALM examiners, the NCUA has opted in favor of five tests, which can sometimes be confusing and at times seemingly contradictory. This can lead to the quandary of which analysis to use and sometimes needless confrontation between examiners and credit unions.

The net interest income simulation (NII) simulation replicates earnings over a period of time. It does not capture cash flows beyond the initial horizon period of the simulation. Therefore, market value volatility of longer-term cash flows is not taken into consideration, and subsequently, its impact is not shown. Maximum rates that are embedded in loans and investments such as adjustable-rate mortgages (ARMs) may not affect income projections if the modeled scenarios do not generate interest rate paths higher than the contractual cap or level of rate restriction. Market value analysis captures the effects of embedded caps even when they are out of the money.

Because of this and other balance sheet traits, one test might show a minimal interest rate risk profile and the other shows high. ***Intuitively this seems flawed; and examiners have written up credit unions as such, however, it is not.*** We have had cases where the two net economic value (NEV) “suggested tests” place client credit union profiles in the “high-risk” category, while the two NII “suggested tests” place profiles in the “low-risk” category. While both should be performed, we believe that more credence should be put in the NEV analysis; without it, long-term cash flows and embedded options (i.e., caps) are not adequately tested and measured. While the proposal makes suggestions on the use of Repricing Gap, NII, and NEV, ***we believe that it should emphasize the use of NEV as an IRR measurement and the use of NII more as an ancillary test.*** In addition, we opine that all references to GAP analyses should be struck. It has been proven that Repricing Gap ALM measurements are not meaningful.

The OTS has adopted a measurement table that defines different degrees of interest rate risk. The OTS has selected the NEV¹ ratio as the sole measure of risk exposure for institutions within its jurisdiction. While the OTS will no longer exist past July 2011, the concept of modeling and risk measurement used in this guideline is ideal, because it captures both the size of economic capital ***and*** its sensitivity to changes in interest rates.

¹ The OTS uses a “NPV ratio” as its measurement, which stands for net present value. The concept is identical to the NEV ratio.

As an example, an institution that has a base NEV ratio of 10 percent and a post 200 bps shock² NEV ratio of 7 percent would be deemed to have a moderate amount of interest rate risk. When using this table, the institution would locate the corresponding range for its post 200 bps NEV shock in the first column of the table and follow the line to the right, locating the column that corresponds to its respective interest rate risk sensitivity measure. In the case of this example, the 300 bps (10% - 7.00% = 3.00% or 300bps) result falls in the 201 - 400bp column and dictates a moderate amount of risk.

Summary of OTS Guideline for the “Level of Interest Rate Risk”

Up 200 bps Post-Shock - NEV Ratio	Interest Rate Sensitivity Measure			
	Under 100bp	101 - 200bp	201 - 400bp	Above 400bp
Over 10%	Minimal	Minimal	Minimal	Moderate
6% to 10%	Minimal	Minimal	Moderate	Significant
4% to 6%	Minimal	Moderate	Significant	High
Below 4%	Moderate	Significant	High	High

We suggest that the table be modified to up 300bp movement with more categories as shown below.

Suggested NCUA Guideline for the “Level of Interest Rate Risk”

Up 300 bps Post-Shock - NEV Ratio	Interest Rate Sensitivity Measure				
	Under 100bp	101 - 200bp	201 - 300bp	301 - 400bp	Above 400bp
Over 10%	Minimal	Minimal	Minimal	Minimal	Moderate
6% to 10%	Minimal	Minimal	Minimal	Moderate	Significant
5% to 6%	Minimal	Minimal	Moderate	Significant	High
4% to 5%	Minimal	Moderate	Significant	High	High
3% to 4%	Moderate	Significant	High	High	High
Below 3%	High	High	High	High	High

This table tackles both the size of economic capital and its changes to interest rates in one test and eliminates the question of two NEV tests and the potential of two separate outcomes.

² The OTS risk measurement table assumes a 200bp after shock value.

IV. IRR Measurement and Monitoring
C. Components of IRR Measurement Methods
4. Assumptions

Different rates used for NEV versus NII

NII is vastly different than the net economic value analysis (NEV). NII is a measurement of earnings volatility, while NEV is an assessment of economic value volatility. Therefore, it is imperative that different rates be used for discounting cash flows for purposes of the NEV than reinvestment rates for the NII.

The NEV analysis should capture the “economic” value of assets and liabilities; which are based on the projected cash flows of your portfolio and the opportunity cost of owning them. As credit unions attempt to shrink balance sheets, deleverage, increase capital to asset ratios, or rid themselves of non-performing assets, economic value becomes critical. Upon the sale of an asset class, cash flows in their entirety need to be evaluated, not just the first one to five years (generally the time period of a NII simulation). The fair value of the asset class is contingent upon rates required from a willing buyer, not the rates that are being offered internally.

Reinvestment rates for purposes of NII should be the credit union’s current offering rates. The base case scenario of a net interest income simulation assumes a static balance sheet, where principal cash flows are typically reinvested into the same asset or liability. If a credit union elects to offer a loan at a rate lower than the prevailing market rate in order to gain market share or reward a member, income will obviously be affected. Should that same lower rate be used in the NEV analysis, the loan is then assumed at par, with no economic gain or loss. In reality, an immediate loss should be inherent in the base NEV.

We believe that the guidelines should suggest two different sets of rates for NII and NEV.

The Use of Par Values for Non-Maturing Deposits

Par values recognize no economic gain or loss in the value of non-maturing deposits. Placing par values on all non-maturing deposits provides equal modeling results between having 100 percent of funds in money market accounts paying six percent, or 100 percent in share drafts paying zero percent. Not only is this erroneous but such an assumption could be dangerous as credit unions discount the value of growing deposit accounts, especially when the NCUA encourages strategic decisions based upon modeling results. Obviously, net interest margins (and subsequently net economic values) are grossly affected by such decisions.

Industry theory generally holds that if a credit union attracts funds at lower rates than its borrowing costs, it creates economic value in its balance sheet. Using par values for non-maturity deposits ignores the franchise value created by this deposit gathering function and instead embraces the assumption that rates paid on these accounts will correlate 100 percent with overnight funds. In those rare instances of aggressive, high-dollar money market accounts, this might be an acceptable assumption, but would be the exception. Deposit franchise premiums are also clearly visible in bank and thrift acquisition analysis.

The greatest weakness of this method is understating liability duration, causing the end user to miss the *danger of spread compression in a downward rate environment*. We know that in practice, non-maturing liabilities do have duration as accounts remain with an institution over time, regardless of the prevailing interest rate environment and dividends paid.

We recommend that the NCUA totally eliminate ANY suggestion or guideline using par values in non-maturing deposits. This brings great confusion to the industry. Examiners should not suggest this exercise merely because a non-maturing deposit analysis is in doubt. *At a minimum, guidelines should suggest some distinction between a money market account that highly correlates to market rates versus share drafts at zero cost.*

V. Internal Controls

The document outlines internal control guidelines for safe and sound IRR practices. While we believe these guidelines to be valid, we also believe that the proposal fails to address an inherent conflict of interest that exists in those situations where the ALM service provider is also the broker/dealer from which the credit union is purchasing an investment security.

On numerous occasions, we have seen erroneous ALM reports provided in order to justify the purchase of investments with higher risk profiles. Broker/dealer representatives' compensation is generally tied to maximizing profit on a per transaction basis, which creates a strong incentive to sell. Objectivity should be the ultimate component of investment selection, however, broker/dealers occasionally use free ALM reports to support products sold, an inherent conflict. At ALM First, we pride ourselves in offering unbiased, fee-based financial advisory services and risk management reporting. As a registered investment advisor, ALM First transacts on behalf of clients through multiple dealers, based on the client's risk tolerance and overall portfolio or balance sheet strategy. Contract fees for financial advisory services are set annually and are based upon asset size rather than investment transactions.

We hope you find these suggestions useful and welcome any future dialogue.

Sincerely,



Emily Moré Hollis, CFA
Founding Partner