[redacted]

CUNA
Credit Union National Association
HONE: 202-638-5777 | FAX: 202-638-7734 | 601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 |
cuna.org

[redacted]

May 23, 2011

Ms. Mary Rupp
Secretary to the Board
[redacted]
Alexandria, VA 22314

Re: CUNA's Comments on NCUA Proposed Rulemaking for Part 741, Interest Rate Risk Proposal

[redacted]

Dear Ms. Rupp:

This letter represents the views of the Credit Union National Association on the agency's proposal to amend Part 741 of its regulations to add a new rule on credit unions' policies and management of interest rate risk (IRR). By way of background, CUNA is the largest credit union advocacy organization in this country, representing about 90% of the nation's 7,400 state and federal credit unions, which serve approximately 93 million consumers. CUNA's comments were developed under the auspices of our Examination and Supervision Subcommittee and the CUNA CFO Council. CUNA Senior Economists Bill Hampel, Mike Schenk, and Steve Rick also contributed to this letter.

Summary of the Proposal

NCUA is proposing to amend its regulation on federal share insurance to include a requirement that federally insured credit unions must have a "written interest rate risk policy and an effective interest rate risk management program, " unless exempted as provided under the proposal. If affected federally insured credit unions fail to develop and maintain such a policy and program, they would risk losing National Credit Union Share Insurance Fund coverage for their members' accounts.

As NCUA knows, the cumulative regulatory burden on credit unions is at an all-time high, due not only to NCUA's activities but also to the flood of new rules being issued by other agencies, including regulations pursuant to the Dodd-Frank Act. Acknowledging the growing regulatory burden on financial institutions, Federal Reserve Board Chairman Ben Bernanke stated May 17, 2011:

> Regulators must aim to avoid stifling reasonable risk-taking and innovation in financial markets….

In light of this situation, any new rule bears an especially heavy burden of justification. New rules should be added to the list only if they are clearly warranted based on a compelling need. We do not believe the agency has provided sufficient evidence that such a need exists here.

CUNA has consistently supported appropriate safety and soundness regulations that are well-tailored to address problem areas and that enhance strong yet reasonable oversight. Further, CUNA has urged all credit unions, no matter how large or small, to manage all the risks they undertake well, including IRR. CUNA offers a comprehensive program of training and education for credit unions to enhance their risk management strategies and skills.

However, while we support proper IRR management and urge credit unions to ensure they have adequate IRR policies and comprehensive IRR management programs, we do not agree that a new regulation on interest rate risk, that would be a condition of federal insurance, inviting micromanagement from agency examiners, is justified. Our view is reinforced by the agency's own assessment of credit union's IRR management. The *Supplementary Information* that states:

> In the past, NCUA issued guidance on ALM and IRR management in Letters to Credit Unions and believes **FICUS generally are managing IRR adequately** (emphasis added).

The proposed rule, if adopted, would result in a significant overlap between the rule and existing agency guidance on asset/liability management and concentration risk. Moreover, as discussed below, sufficient supervisory mechanisms already exist for the agency to monitor, assess and direct corrections be made to any deficiencies in credit unions' interest rate risk policies and management.

Why a New Regulation as Proposed Is Not Warranted

NCUA officials have indicated that credit unions' IRR management is much more of a concern to the agency than this issue is for bank regulators. The *Supplementary Information* to the proposal does not quantify or elaborate on NCUA's concerns and simply states:

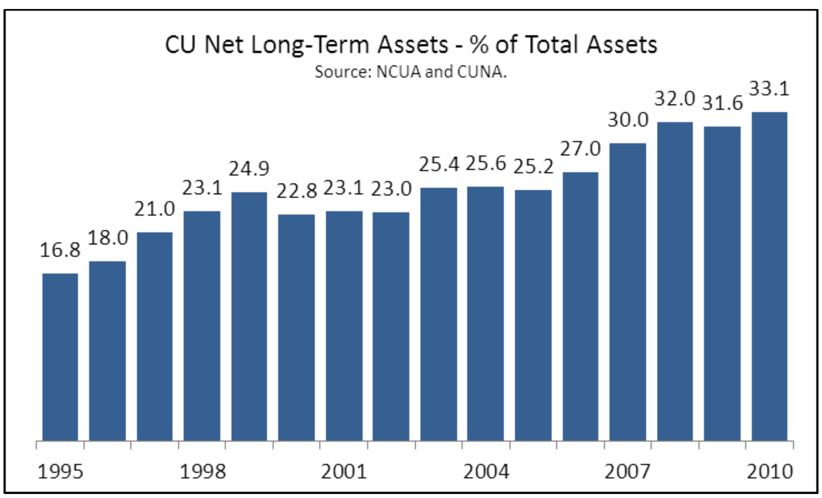
> IRR has risen at credit unions due to changes in balance sheet compositions and increased uncertainty in the financial markets. The Board therefore believes it is appropriate to create a regulatory requirement addressing the policy and practice of interest rate risk management at FICUs supported by clear and comprehensive guidance.

CUNA agrees that overall IRR exposure has grown recently. As CUNA's economists have reported, credit unions have experienced substantial deposit inflows in the wake of the financial crisis and most of the inflows have been placed in short-term, liquid accounts that re-price quickly. In addition, historically low interest rates have led to large numbers of mortgage re-financings and increased the demand for purchase money mortgages. Credit unions originated record levels of mortgages in 2009 and mortgages remain one of the fastest-growing segments of credit union loan portfolios.

- Credit union first mortgage portfolios have doubled in the past twenty years – from 12.5% of total assets in 1990 to 17.5% of assets in 2000 and to 24.5% of total assets at year-end 2010.

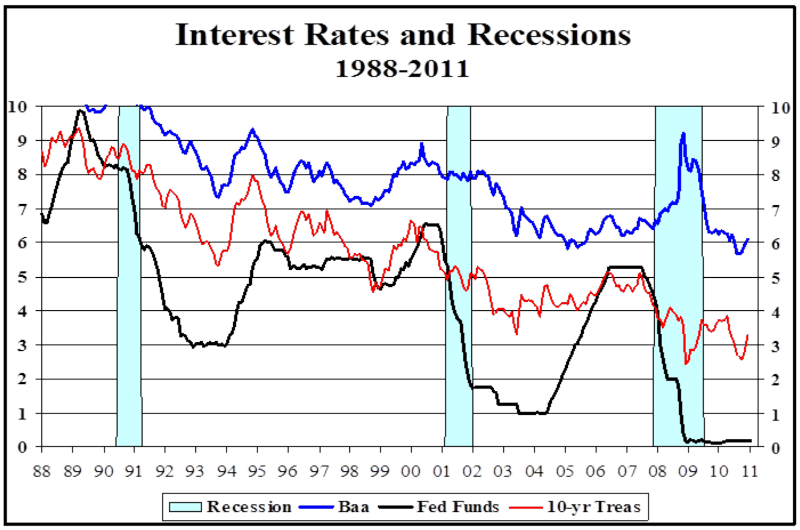
- At year-end 2010, 60% of credit union first mortgages were fixed-rate first mortgages and nearly two-thirds (61%) of the fixed-rate mortgages in CU portfolios were long-term (15+ year) fixed-rate mortgages. Credit union exposure to these long-term (15+ year) fixed-rate mortgages has increased markedly in the recent past. In 2004 (the earliest comparative data we have) only 46% of CU fixed-rate mortgages were long-term.

- Credit union net long-term assets as a percent of total assets have increased to one-third of total credit union assets in 2010 – about double the level reported fifteen years ago.

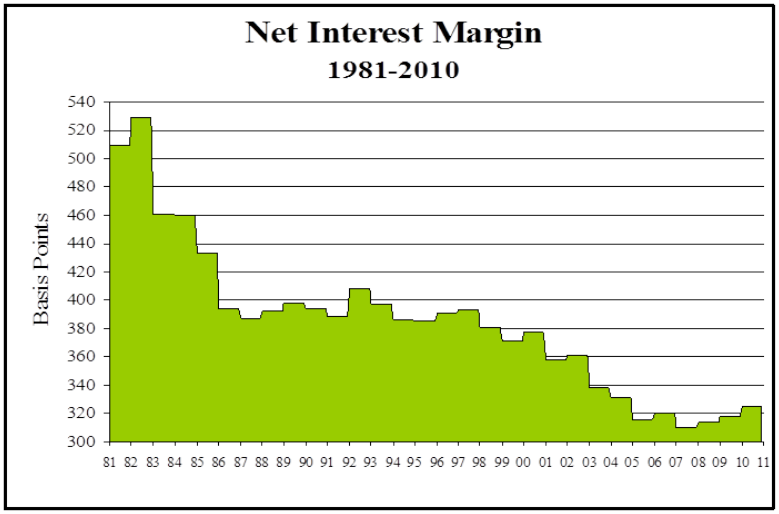


However, data also show that credit unions have generally managed their interest rate risk exposure quite well recently, and over the last two interest rate cycles. During the current cycle, after long-term mortgages rose as a proportion of assets in 2007 and 2008, credit unions have dramatically increased their sales of first mortgage originations, to over 50% of originations from the more typical 25% to 30%. 2009 saw a record $50 billion in sales of first mortgage loans. This is strong evidence that credit unions "get it" and are actively managing their IRR exposure.

Considering previous interest rate cycles, a rising interest rate environment should produce the greatest interest rate risk for a typical financial institution that uses short-term deposits to fund longer-term assets. During the rising rate environment of February 1994 to March 1995, the Federal Reserve raised the Fed funds interest rate 3 percentage points (see chart). Credit union net interest margins (NIM, or asset yields minus funding costs) fell one basis point in 1995, from the 386 basis points reported in 1994. Net interest margins actually increased 5 basis points in 1996 and 7 basis points in 1997 from the 1994 level. Again, strong evidence that credit unions managed their interest rate risk exposure.



More recently, from July 2004 to June 2006 the Federal Reserve raised the Fed funds target interest rate from 1% to 5.25%. Using credit union's 2004 net interest margin (331 basis points) as the base line, net interest margins fell 15 basis points in 2005, and were down 11 basis points in 2006. Considering the 425 basis point increase in market interest rates, that modest level of NIM decline is also strong evidence of effective interest rate risk management.



This strong management by credit unions of their interest rate risk during this period is reflected in NCUA's 2007 *Annual Report* to the President and Congress:

> Credit unions continue to demonstrate strength and stability in turbulent financial markets. Industry-wide net worth stands at a strong 11.4 percent and members grew by 1.3 percent….Savings expanded a healthy 5.6 percent and first mortgage loans grew 12.3 percent, suggesting that credit unions are fulfilling their mission to provide fairly priced financial services by stepping in to meet real estate loan needs during a tumultuous time in the mortgage lending market.

The next rising rate environment is forecasted to start in the first quarter of 2012, although it could of course happen at any time. The Federal Reserve is not expected by most economists to raise interest rates as quickly this time compared to the previous two periods mentioned above, due to abnormally high unemployment and a large output gap (current GDP below potential GDP). This timetable would give credit unions ample opportunity to adjust their balance sheets to minimize any adverse effects on their net interest margins. Moreover, due to credit unions current large holdings of excess liquidity, they will be slow to raise their deposit interest rates, mitigating any interest rate risk exposure caused by their record levels of long-term assets.

The strong interest rate risk management by credit unions in the past is no accident. It is the result of robust asset liability management policies already in place in credit unions, backed up by effective tools and implementation. The agency already has all the tools it needs to monitor adequate interest rate risk management. It can do this by having examiners review ALM policies and practices in place at credit unions. We believe there is no need for a separate rule on IRR.

NCUA Already Has Sufficient Means to Ensure Credit Unions Develop and Maintain Effective IRR Policies and Management

In January 1010, the Federal Financial Institutions Examination Council issued an advisory on IRR management, which was adopted by all member agencies, including NCUA. The purpose of the advisory was to address expectations of regulators for all financial institutions to manage their IRR exposures by utilizing evaluation methods and systems that reflect their net worth, complexity, operations and other issues. In large measure, the advisory forms the basis of the regulation NCUA is proposing.

NCUA's proposal is closely based on the advisory. While the *Supplementary Information* acknowledges that it is "impossible to establish specific, regulatory requirements for IRR that would be appropriate for all FICUS," the proposed rule would nonetheless rely on credit unions' implementation of proposed "guidance" that accompanies the proposed rule changes. In other words, the guidance would be used by examiners as "specific, regulatory requirements for IRR." If past practice is any indication of future performance, examiners will utilize the guidance as a checklist and rigidly enforce it.

It is our understanding that examiners are currently utilizing the advisory as a tool to help evaluate the adequacy of credit unions' IRR policies and management, including how well institutions are documenting, monitoring and updating key assessments they use in assessing their IRR management. It is also our understanding that credit unions rely on the advisory as well. We feel this is appropriate and sufficient for safety and soundness purposes, given the fact that IRR policies and management programs cannot be the same for all credit unions. Also, we do not agree that NCUA has provided sufficient evidence of concerns to support moving from the use of the advisory to a regulation.

NCUA cites a figure of 800 FICUs that will need to develop a written IRR policy to comply with the proposal. In our view, NCUA should focus first on these credit unions before adopting a new rule that applies across the board to all credit unions

The Proposed Guidance Would Become a Checklist for Examiners for IRR Policies and Programs

NCUA has proposed detailed guidance on IRR policy and programs. The guidance is comprehensive and addresses the range of issues credit unions need to be concerned about and mange in their IRR policies and programs; the proposed guidance is an outgrowth of the previous advisory issued in January 2010.

However, while the appendix provides generally excellent guidance, there is a real concern as to how such guidance will be utilized in the hands of examiners.

There is nothing in the rule to prevent examiners from using the guidance as a checklist for compliance. Given the structure of the proposed rule, two major questions arise which have not been sufficiently addressed by the agency:

- If a credit union does not comply with the guidance will it be in jeopardy of losing its NCUSIF coverage?
- How much flexibility will credit unions have to deviate from the guidance?

In addition, depending on how examiners utilize the guidance, the level of detail in the proposed guidance could actually undermine a risk-based approach to IRR management. That is because of the concern that examiners will enforce the guidance rigidly and that credit union officials would not be allowed to tailor their approaches to IRR management based on their own determinations of what is best for their credit union.

If NCUA goes forward with this rule, and we urge it not to, the final rule should specifically provide that the failure to meet an examiner's subjective evaluation of the credit union's IRR policy or management or the failure to comply with an examiner's preference regarding an IRR policy or program will not subject the credit union to the loss of NCUSIF coverage. In addition, if the proposal is adopted and because NCUSIF insurance is at stake, there should be a specific, well-described, transparent process for credit unions to appeal to NCUA senior management and the Board depending on the severity of the issue, regarding IRR, without fear of retaliation.

In addition, the guidance should clarify that credit unions have the ability to choose which IRR measurement methods they want to use as long as the methods are effective and assist the credit union in identifying, managing and correcting risks and that examiners will not require one method over another. Also, the guidance states that where possible, risk taking and risk measurement should be separated. However, agency expectations should be clarified and examples provided of situations that NCUA would find acceptable where the functions for risk taking and measurement are not strictly separated.

IRR Management and Policy Compliance Should Not be Tied to the NCUSIF

CUNA does not agree with the agency's brief justification for making compliance with the requirements of the proposal a condition that credit unions must meet to obtain and continue National Credit Union Share Insurance. In the *Supplementary Information* to the proposal, the agency notes that compliance with lending and investment policy requirements is also a condition of NCUSIF insurance and that including the IRR requirements is consistent with that approach and appropriate.

We do not think this analysis withstands scrutiny. The lending and investment authorities, which are fundamental activities, and related prohibitions are specifically detailed in the Federal Credit Union Act. While significant, the issue of IRR management is a regulatory directive and is not addressed in the Act.

Even more important, compliance with IRR management must be tailored to a credit union's operations, financial condition and membership needs, which means it is subjective – as noted by the *Supplementary Information.* Likewise, examiners' evaluations of credit unions' policies and IRR management must reflect that such policies and management will need to differ based on the credit union's circumstances. This is quite a different situation from whether or not a credit union has met objective lending or investment requirements that apply consistently and upon which both credit unions and examiners may routinely rely without much subjective analysis.

Also, we believe making compliance with the IRR management and policy requirement a condition of NCUSIF account coverage is a punitive and unnecessary step that the agency does not need to take. To impose the additional sanction that insurance could be lost based on the examiner's subjective evaluation of the credit union's IRR management and policies is inappropriate and unwarranted.

If Adopted, Coverage of the Rule Should be Limited and Compliance Phased-in

For some time, CUNA has been urging NCUA to tailor its requirements by activities and asset size and the proposal contains such exceptions. However, if the proposal proceeds despite the lack of evidentiary support for it, we urge the Board to raise the threshold from $10 million to $50 million and to adjust the concentration trigger to include only fixed-rate mortgages. We believe these changes would not undermine safety and soundness and would help to target risks more directly.

We also think that there should be a phase-in period of one year for compliance for all institutions that would be affected, should the Board approve the rule, rather than the three month period indicated in the *Supplementary Information.*

Conclusion

CUNA does not support the promulgation of a final rule based on the proposal. Among other concerns, the agency has not provided sufficient evidence in the *Supplementary Information* that such a rule tied to NCUSIF coverage requirements is necessitated at this time. Rather than adopt a new rule, we recommend the agency make the guidance available on its website as an important resource for credit union officials to use in developing and maintaining IRR policies and management programs that fit the risk profile of each credit union.

Sincerely,

Mary Mitchell Dunn

Mary Mitchell Dunn
CUNA SVP and Deputy General Counsel