The Four Pillars of Interest Rate Risk Management

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Examiners will criticize asset concentrations that are not effectively managed.

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In January 2014, NCUA issued Letter No. 14-CU-02, which urges credit unions to “identify and mitigate forward-looking risks before they threaten the viability of credit unions and the stability of the Share Insurance Fund.

“Interest rate risk [IRR],” the agency wrote, “is the most significant risk the industry faces right now.”

As rates have risen above record lows, some credit unions’ unrealized gains have swung to unrealized losses, according to NCUA. “These unrealized losses may foreshadow the actual losses credit unions will face if continuing rate increases eventually result in more compression of net interest margins.”

It is hard to envision a higher rate environment given the Fed’s continued “easy money” policy and the tendency for long-term rates to quickly drop to lower levels whenever fear of geopolitical risk rattles the equity markets.

However, gradual increases in rates could have significant consequences for credit unions with high concentrations in certain long-term investments and loans.

NCUA states it is imperative for credit unions to make the necessary adjustments to account for a rising-rate environment. But what does this mean?

First, credit unions should be familiar with the four pillars of IRR management:

1. Clear and concise IRR policies and risk limits.
2. Frequent risk measurement and reporting.
3. Internal controls and audit to ensure compliance with policies and risk limits.
4. Effective board and senior management oversight and actions to maintain compliance with risk limits and IRR policies.

A credit union's IRR tolerance should be communicated so the board of directors and senior management clearly understand the risk tolerance limits and the impact of IRR on earnings and capital adequacy.

Credit unions should evaluate their risk tolerance frequently and adjust it where applicable, especially for long-term fixed-rate loans. These assets are the most difficult to manage from an IRR standpoint.

Management is responsible for the implementation of IRR policies. The policies should have supporting procedures and internal controls addressing IRR management, including limits and controls over risk-taking to stay within board-approved tolerances.

IRR policy typically expresses limits in terms of changes in the credit union's net interest income and net economic value (NEV) given interest rate shocks up to +/- 400 basis points (bp).

The IRR policy should document the IRR model and how management validates the assumptions used in the model. General assumptions of the credit union's asset/liability management (ALM) should be reviewed at least annually.

Specific ALM assumptions should include market-based prepayment assumptions for loans, the potential runoff of nonmaturity shares, and the early redemption of time shares. The duration assumptions of investments should also be market-based and documented.

The policy should also include requirements for periodic back testing to evaluate the assumptions used for historical model analyses.

Shock scenario assumptions also are important. Typically, a parallel shift in short- and long-term rates is used as a starting point.

Nonparallel interest-rate shifts may be appropriate depending on the composition of the loan portfolio, investments, deposits, and borrowings. Nonparallel shifts may identify IRR mismatches that do not emerge in a parallel shift.

Instantaneous and extended shifts also inform management and directors of IRR risks for a particular credit union balance sheet. Stress scenarios should be tailored to the credit union's balance sheet and member base.

Reporting is crucial

Sufficiently detailed reporting processes to inform senior management and the board of the level of IRR exposure are required. The net interest income report should provide anticipated values that will affect the credit union's income statement at various rate-shock levels.

The NEV provides anticipated values that will affect the credit union's balance sheet and equity at various shocks levels. The stress scenarios should also model remediation plans in advance of a rise in interest rates.

The board may require management to establish "triggers" as IRR approaches policy limits. Triggers can be an effective early warning system to ensure the board is aware of trends that approach policy limits.

For example, a credit union may establish a NEV limit of +/-35% based on a 400 bp shock. Triggers may be established if the NEV exceeds 30% as an early warning of a possible risk limit issue that requires modeling potential remediation opportunities.

If triggers or limits are breached, a credit union can remediate IRR with active management. Active management is especially important for institutions with a high concentration of long-term fixed-rate assets.

Concentrations that are not effectively managed can become areas of criticism by examiners. ALM can undertake a variety of actions:

• **Sell** securities with longer repricing durations to manage IRR and create short-term liquidity.

• **Initiate** longer-term, fixed-rate borrowings to reduce IRR.

• **Sell** properly originated mortgages as whole loans or swap them into mortgage-backed securities.

Recently, Fannie Mae has been more accommodating in swapping whole loans into mortgage-backed securities, but expect a lengthy period of time for negotiating the swap contract and due diligence. Some credit unions explore this option from time to time as a potential remediation.

• **Become** a seller/servicer with Fannie Mae or Freddie Mac to sell fixed-rate loans into the secondary market while retaining the servicing and member relationship.

• **Offer** more variable-rate loan options for members (i.e., home equity lines of credit, home improvement loans, home construction loans), and price the trade-off between current yield and IRR.

• **Adjust** rates paid to members for nonmaturity shares to maintain or increase the nonmaturity component of the liability mix.

Effective IRR includes an engaged board, clear policies and risk limits, and exploration of remediation opportunities.

The board should regularly assess and document the adequacy and effectiveness of the credit union's IRR management process and its IRR exposure.

The board and management also should document how it considered the credit union's asset size and balance sheet composition, the nature and complexity of its activities, the member base, and the adequacy of its capital and earnings in relation to its overall IRR profile.

This documentation should satisfy regulators that management and the board have adequately addressed the safety and soundness issues around IRR. Most importantly, a sound plan for IRR management will ensure that your credit union is fully prepared for all potential interest rate scenarios.

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