The New IRR Rule

Be Prepared To Defend Your A/LM Policy And Program

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The National Credit Union Administration recently issued its final rule requiring "federally insured credit unions to develop and adopt a written policy on interest rate risk management and a program to effectively implement that policy, as part of their asset liability management responsibilities. The interest rate risk policy and implementation program will be among the factors NCUA will consider in determining a credit union's insurability" (p. 5,155).

"Interest Rate Risk Policy and Program Final Rule" http://www.gpo.gov/fdsys/pkg/FR-2012-02-02/pdf/2012-2091.pdf is effective as of Sept. 30. Credit unions over $50 million in assets are required to have a written interest rate risk policy and an effective IRR program. Credit unions over $500 million can expect their IRR policies and processes to be put under a microscope. Credit unions from $10 million to $50 million with first mortgage loans and long-term investments equal to, or exceeding, 100 percent of net worth are subject to these new rules as well.

While we are not proponents of more regulation, this new rule provides a great opportunity – even if it is forced – for credit union managements and boards to ensure they are on the same page with respect to appetite for risk, risk quantification methodology and process. The timing could not be better as we sit in the lowest rate environment our financial markets have experienced since the 1950s.

The spirit of this new rule is to get boards and managements to proactively use policy and measurement tools to protect against IRR. Again, this is a worthy objective. However, as boards and managements work toward this objective, they should be aware of unintended consequences.

Drifting To A *One-Size-Fits-All* Approach

No doubt, there will be problems with the implementation of the new rule. The rule by design and necessity is ambiguous. As NCUA stated, "…it is not possible to establish a 'one-size-fits-all' template of IRR management standards and metrics that would be appropriate for all FICUs. Rather, it recognizes that IRR management requires *specialized judgments* based on each credit union's business objectives and ability to withstand risk [emphasis added]" (p. 5,156).

This rule will likely require more work for boards and managements to explain *why* they believe their credit union's IRR policy and program are appropriate and effective. However, we believe credit unions should be relieved that NCUA did not spell out exactly *how* all credit unions should quantify and manage interest rate risk. That would have been a serious disservice to the industry.

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Strategy and risk management are inextricably linked. If NCUA drifts to a *one-size-fits-all* approach for risk management, there is a very high risk that strategies will no longer be unique. This would make it difficult for credit unions to differentiate, which can negatively impact their ability to compete, likely posing a material threat to the industry.

The lack of a *one-size-fits-all* approach comes with its own risks. A significant risk is in how the rule is interpreted by examiners. It is easy to say on paper that *one-size-fits-all* is not the intent. It is much more difficult to ensure that implementation of the rule does not result in a *one-size-fits-all* approach. Whether a credit union has a written policy with adequate limits and an effective program addressing IRR *may ultimately be determined by each credit union's most recent examiner.*

Establishing Risk Limits That Really Don't Align With Appetite For Risk

It is human nature to avoid conflict – more so when examiners are involved. Unfortunately, an unintended consequence of this rule is the likelihood that boards and managements will establish policy limits that are perceived to be the minimum with which they can get by. The objective in taking this path is to avoid ever being outside of policy to reduce the potential hassle with examiners. This is clearly a potential downside of having this new rule in place. It is critical that strategy and risk management, including limits, be linked. If a strategy carries material risk, the limits should be set to protect the institution, not simply pass a perceived minimum standard.

Establishing Clearly Defined Risk Limits And Rationale

In an effort to determine if a credit union has an adequate policy and/or IRR program, field examiners will likely increase their reliance on comparability of risk limits and key assumptions across credit unions. This could lead to each credit union having to use a standard set of assumptions so it is easy for field examiners to compare credit union to credit union.

To reduce this risk, boards and managements should have clear rationale for their established risk limits and key assumptions. Further, they should automatically perform stress tests of key assumptions on a regular basis. Having these items documented and readily available to hand to an examiner could mitigate issues that may arise as a result of the new rule.

Understanding Key Points To Protect Against *One-Size-Fits-All*

The rule provides a table of guidance in Appendix B. However, don't limit your interpretation to this appendix. NCUA made many key points in the rule. The following points and statements are highlighted from the rule to help credit union executives be better prepared should an examiner apply a *one-size-fits-all* approach to their institution:

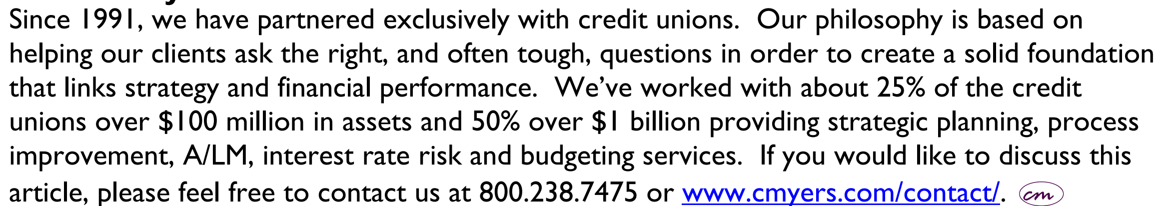
- The rule explains that the exposure to IRR can have a direct impact on earnings, net worth and net economic value, and acknowledges that net worth and net economic value are not synonymous.
- Though it specifies earnings and net economic value as measures, the rule clearly states, "net worth is the reserve of funds available to absorb the risks of a credit union, and it is therefore *the best measure against* which to gauge the credit union's risk exposure [emphasis added]" (p. 5,158).

- NCUA states “that it does not seek to endorse certain IRR measures, measurement techniques, or assumptions over others” (p. 5,160).
- With respect to NEV, “…NCUA does not prescribe valuing non-maturity shares at par but it acknowledges that such measures and the use of historical rate scenarios may provide useful information. Similarly, NCUA does not require discounting on yield curves or endorse any particular discount rate” (p. 5,160).

If you only remember two things as this new rule goes into effect:

1. Link strategy with risk management by establishing risk limits that align with the institution’s goals and appetite for risk.
2. Understand, use and be prepared to clearly defend appropriate policies and IRR processes that are customized for your unique situation and strategic objectives. You’ll not only meet the requirements of this rule but also be in a better position to protect net worth as the world around you changes.

About c. myers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