STRATEGIC INSIGHTS FOR POLICY MAKERS

# CREDIT UNION Directors NEWSLETTER

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# Proactively Manage Interest Rate Risk

***Adopt safety and soundness practices to address NCUA's new review procedure.***

While NCUA constantly monitors all risk, in recent years it has made interest rate risk (IRR) a particular priority.

IRR reflects the concern that an investment's value will change due to a variance in the absolute level of interest rates. That change affects the value of bonds more than stocks, and depends on the investments' sensitivity to changes in the market. Credit unions can reduce overall risk by diversifying the duration of investments it holds at a given time.

While to some degree IRR is inherent in all credit unions, it's potentially a significant risk in certain organizations, due to mismatches of asset/liability maturity and the types of shares and deposits used to fund loans.

So, it's critical for the board to adopt safety and soundness practices to address NCUA's new IRR review procedure—to stay in compliance and protect your credit union.

During the past 10 years, many credit unions have grown significantly, in size and complexity. At the same time, risk management techniques have improved to support these organizations, and the same principles can protect smaller credit unions.

**THE NEW NCUA REVIEW PROCEDURES INCLUDE A 'SHOCK TEST' REQUIREMENT FOR CUs.**

IRR can be prevalent in non-703 investments, which credit unions often use to fund Charitable Donation Accounts, benefits prefunding programs, and funding of 457(f) nonqualified deferred compensation plans. NCUA doesn't permit some of these investments outside of this context because of their higher risk profiles, despite their higher earnings potential.

Effective Jan. 1, 2017, after years of analysis, NCUA implemented changes to its IRR review procedures. Key changes to IRR supervision include:

- **Developing** the Interest Rate Risk Review Procedures Workbook;
- **Updating** IRR tolerance thresholds in the Net Econo-mic Value Supervisory Test;
- **Creating** an estimated net economic value tool (for credit unions with total assets of $50 million or less); and
- **Revising** the IRR chapter in the Examiner's Guide.

These changes aim to support the efficiency and effectiveness of NCUA examinations, and allow examiners to focus on higher-risk credit unions. The changes will address new rule requirements, enhance examiner guidance, reduce inconsistency, and identify outlier risk.

continued ▶

## QUICK TAKE FOR YOUR NEXT BOARD MEETING

### Offer value and ease of use

Four key findings in Accenture's North America Consumer Digital Banking Survey reveal that financial institutions (FIs) must provide value to customers while delivering an easy and seamless experience through physical and digital channels.

**VALUE MATTERS**
**45%** of consumers say they'd stay loyal if their FI offers discounts on key purchases.

**SWITCHING IS EASY**
**11%** of consumers left their FI in the past year—and many are switching to virtual banks.

**ROBO-ADVICE IS WELCOME**
**46%** of consumers are willing to bank using robo-advice in coming years.

**BRANCH IS ALIVE AND WELL**
**87%** of consumers will use their branches in the future—and they want human interaction.

**Source:** *Accenture North America Consumer Digital Banking Survey*

- CUNA Mutual Group resources: *cunamutual.com/total-benefits-prefunding*
- CUNA Environmental Scan resources, including the 2017-2018 report, available in June: *cuna.org/escan*

## Managing IRR

Credit unions can take actions to minimize risk, but first must understand the risks specific to their organization. As long as you can determine how your balance sheet will perform in a rising and/or declining interest rate environment, you should be able to plan ahead.

IRR depends on how and why rates rise, and whether that occurs consistently across investment vehicles. You'll need to determine how your credit union must match market rate increases to maintain deposits, and consider how quickly rates are changing.

New NCUA supervisory rules require examiners to assess a credit union's risk inherent to interest rate changes by conducting a "shock test," which assesses the impact of a 300 basis point increase in interest rates. This shock test uses the credit union's Call Report data, ensuring accuracy and relevance.

The net result is a corresponding decrease in net worth and capital position, showing whether a rapid rise in interest rates could cause insolvency.

Knowing this, a credit union can identify the investments or loans that represent the greatest risk and plan accordingly. Generally, investments and loans that carry the longest durations and highest interest rates will represent the greatest risk to changes in interest rates.

By limiting the credit union's exposure to long-term investments and loans, and balancing the durations of all assets, you can more easily prepare for interest rate increases. Diversifying investments into different categories—particularly investments that aren't interest sensitive—also can help.

Last, the credit union can divest itself of investments and loans that might be more sensitive to interest rates.

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## Top NCUA Exam Priorities in 2017

CUNA Chief Compliance Officer Jared Ihrig writes in CUNA's 2017-2018 Environmental Scan Report that, in addition to interest rate and liquidity risk, NCUA examiners will focus on these priorities in 2017:

- **Cybersecurity assessment.** NCUA continues to "carefully evaluate" credit unions' cybersecurity risk management practices. The agency recommends credit unions use its Cybersecurity Assessment Tool, which NCUA integrated into its exam processes.
- **Bank Secrecy Act compliance**. NCUA will continue to focus on credit unions' relationships with money services businesses and other accounts that might pose a higher risk for money laundering.
- **Internal controls**. Credit unions should address weaknesses such as inadequate board policies, inactive supervisory committees, lack of mandatory vacation policy, failure to maintain adequate audit trails, and inaccurate or incomplete records.
- **Commercial lending**. NCUA's revised Part 723 went into effect Jan. 1, 2017. Credit unions should note key changes from the previous regulation. These include giving credit union loan officers the ability, under certain circumstances, to not require a personal guarantee.



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