NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA

DATE: **July 2003** **LETTER NO.: 03-CU-11**

TO: **Federally Insured Credit Unions**

SUBJ: **Non-Maturity Shares and Balance Sheet Risk**

Dear Manager and Board of Directors:

This letter follows a series of letters issued on the subject of balance sheet risk management.[1] Previous guidance informed credit unions about the need to effectively manage liquidity and interest rate risks. This letter focuses on a more specific component of these risks: the measurement and evaluation of non-maturity shares.

PURPOSE. This letter is intended to provide guidance to credit unions on sound practices for evaluating behavior of non-maturity shares in the context of managing risk. It does not seek to define the treatment to be used by credit unions, but instead is intended to promote a basic framework of best practices from which credit unions can make their own assessment. Understanding the behavior of non-maturity shares is integral to understanding the risks, particularly interest rate and liquidity risk, inherent in the balance sheet as a whole. Management should establish appropriate policies and practices and maintain proper documentation relative to the individual circumstances of the institution.

SCOPE. This letter applies to all credit unions that have complex balance sheets (e.g., mortgage loans, or investments with long maturities, embedded options and/or complex coupon formulas) necessitating quantitative analysis of interest rate and liquidity risks. Small credit unions with basic asset structures (e.g., signature and auto loans and short-term investments) are excluded from the scope of this guidance.

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[1] Previous letters: 99-CU-12, August 1999, "Real Estate Lending and Balance Sheet Management;" 00-CU-13, December 2000, "Liquidity and Balance Sheet Risk Management;" 01-CU-08, July 2001, "Liability Management – Highly Rate Sensitive and Volatile Funding Sources."

This letter assumes that the risk management process guidelines provided by IRPS 98-2 and subsequent letters on balance sheet risk are being followed. The objective of this letter is to identify best practices that relate to the treatment of non-maturity shares, while taking the unique characteristics and individual balance sheet risks of credit unions into account.

BACKGROUND. Non-maturity shares, such as regular shares, share drafts and money market accounts have no contractual cash flows. While balances in these accounts can be withdrawn on demand, typically such accounts experience periodic inflows and outflows (e.g., share deposits and withdrawals). Therefore, while these shares can be a long-term funding source, the uncertain timing of inflows and outflows can make the appropriate treatment of non-maturity shares challenging.

At the same time, dividend rates paid on non-maturity shares are changed at the discretion of the credit union, based on its pricing strategy and the current interest rate environment. This is in contrast to, for example, fixed rate share certificates which generally have a set dividend rate for a specific maturity. This makes it difficult for a credit union to forecast rates that will be paid on these accounts. Credit unions operate in a variety of market environments, have differing member compositions and member needs, and set their dividend rates based on their pricing strategies. For example, a credit union with little competitive pressure and a membership that is not rate sensitive may set low dividend rates on its non-maturity shares and delay increasing dividends when interest rates rise. In contrast, a credit union facing greater competitive pressures may price its non-maturity shares more aggressively, administering changes with less delay and maintaining dividend rates commensurate with its competition. It may also seek to develop additional strategies, such as creating a more diverse share product line, and tiering the rates on its share accounts.

It is not possible to predict with any degree of certainty what the future balances in non-maturity accounts will be, how long they will remain open, or what future rates will be paid to members on these accounts. Even when credit unions study member behavior, or contract with vendors to perform such a study, substantial uncertainty remains. This is due to rapid and continual change in the economic environment and financial marketplace which may not necessarily reflect circumstances from which a deposit study is based.

The uncertain behavior of non-maturity shares poses significant concern for all financial institutions, including credit unions. Interest rates have been declining for the past several quarters and are now at historically low levels, yet the industry has seen a rise in savings growth. Most of this growth has occurred in non-maturity share balances. At the same time, mortgage originations have been peaking as borrowers seek low fixed rate mortgages subjecting credit union balance sheets to the risk of increased cost of funds if rates rise and interest income on long-term fixed rate assets remains constant.

NCUA commissioned a study in 2002 to review technical aspects of non-maturity shares. The study provided recommendations for maturities of credit union shares. After due consideration, NCUA has determined that it will not adopt the study's recommendation for safe harbors. The study's findings and conclusions are superceded by the recommendations in this letter. Credit unions wishing to address technical questions may refer to the study which can be found on NCUA's Web site under Reference Information, Investment/Asset Liability Management, Guidance Papers.

ASSUMPTIONS, MODELS AND METHODS. Credit unions may use a variety of tools and methodologies to assess the risk mitigation of non-maturity shares. This guidance does not advocate any particular approach and recognizes some credit unions may explore multiple methodologies, including those that are offered by third party vendors. However, the guidance does require that the models and methods used should reflect the size and complexity of the credit union as well as significant balance sheet risks under a variety of conditions.

Credit unions must use documented assumptions and methods in their modeling of non-maturity shares that are both reasonable and supportable. Each credit union should evaluate its non-maturity share assumptions after considering, among other factors, current pricing strategies, current and prospective rate sensitivity of its members, current and future economic and financial conditions, and the overall competitive environment used in its assumptions.

BEST PRACTICES. To properly and effectively manage their balance sheets, credit unions should take necessary steps to measure, monitor, and control interest rate and liquidity risks that could evolve when rates rise and the economic climate improves. Steps include adopting sound and prudent policies, procedures, and practices when measuring the behavior of non-maturity shares for purposes of managing risks. Further, credit unions should document their non-maturity share behavior assumptions. Failure to adhere to these principles may result in reduced earnings and capital, and is considered unsafe and unsound.

The individual circumstances of each credit union dictate the best practices it should implement. Credit unions should consider the potential risk exposure as they explore opportunities to better serve their members.

Some credit unions may choose a simple approach when measuring risk. When measuring liquidity risk, they may assume non-maturity shares will be withdrawn immediately. For purposes of projecting net interest income, they may assume that all non-maturity shares are highly rate sensitive and that dividend rates are changed coincident with changes in interest rates. For net economic value purposes, they may assume that non-maturity shares are always priced/valued at

par, or book value. It is recognized these approaches will typically provide conservative risk measurement results, especially in times of rising rates.

Some credit unions may choose to incorporate their forecasted share behavior into their risk identification and measurement processes. This approach assumes that non-maturity share behavior may reflect longer maturities and be less rate sensitive than the simplistic treatment described above. This method generally results in non-maturity shares priced/valued in a way that will produce an increased net economic value. Therefore, the underlying assumptions of the shares require close scrutiny. Credit unions using this approach should incorporate a number of factors into their analysis. Best practices indicate that a credit union should conduct a documented assessment of its member behavior, market conditions and future member needs. Such factors could include, but would not be limited to:

- Credit union pricing strategy;
- Membership growth;
- Presence of local competition;
- Economic conditions;
- Expected levels and trends of interest rates; and
- Credit union liquidity needs.

Credit unions that forecast share behavior and incorporate those assumptions into their risk identification and measurement process will be expected to perform sensitivity analysis reflecting the value of the non-maturity shares by varying the underlying assumptions and relating them to changes and differing levels of interest rates. The sensitivity analysis should be sufficiently rigorous to reflect the potential changes in non-maturity share behavior under stressed interest rate and economic conditions. The sensitivity testing should represent a good faith evaluation whether non-maturity share behavior that differs from the forecast assumptions would create any undue risk to the credit union.

For instance, in cases where interest rates rise sharply or significant economic developments occur, sharp disparities may exist between actual behavior and forecasted behavior. This could lead to unanticipated pressure on a credit union's net liquidity, interest margin and net economic value. If such circumstances were found to exist, the credit union should formulate contingency plans sufficient to mitigate this exposure.

Regardless of the approach taken to address the uncertainty associated with non-maturity shares, credit unions should formulate an approach designed to effectively measure their behavior and to document their assumptions.

CONCLUSIONS. Credit unions should adopt sound policies and procedures when measuring the behavior of non-maturity shares. Credit unions attributing risk mitigation to non-maturity shares (e.g., by lengthening maturities or lagging

dividend rates), should identify and document the assumptions used to forecast their non-maturity share behavior. Failure to adopt such practices and procedures may be considered unsafe and unsound.

Guidance pertaining to non-maturity shares will be incorporated into the Interest Rate Risk Questionnaire and Liquidity Risk Questionnaire. This is intended to help examiners evaluate credit unions' analysis of non-maturity shares and will soon be available on the NCUA Web site at http://www.ncua.gov/ref/Investment/ALM-reviewprocedures.html.

Sincerely,

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Dennis Dollar
Chairman