OFFICE OF INSPECTOR GENERAL

NCUA
National Credit Union Administration

REVIEW OF NCUA'S INTEREST RATE RISK PROGRAM

Report #OIG-15-11

November 13, 2015

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EXECUTIVE SUMMARY

The Office of Inspector General (OIG) conducted this self-initiated audit to determine: (1) whether the National Credit Union Administration's (NCUA) interest rate risk (IRR) policy and procedures help to effectively reduce IRR; and (2) what action NCUA has taken or plans to take to identify and address credit unions with IRR concerns. To accomplish our objective, we interviewed NCUA headquarters and regional management and staff. We also obtained and reviewed NCUA guidance, policies, procedures, and other available information regarding interest rate risk. In addition, we judgmentally selected five credit unions,[1] one from each of NCUA's five regions, and analyzed the corresponding examination and supervision reports and related documents.

We determined that NCUA has taken steps to identify and address credit unions with interest rate risk concerns. Specifically, we determined that:

1. Regional staff plays an important role in identifying credit unions with elevated IRR and that NCUA examiners use multiple methods to assess and monitor IRR;

2. Examiners are essential in assessing IRR and have various tools to help credit unions address IRR concerns; and

3. NCUA established an IRR working group[2] to develop examination-based IRR assessment tools and IRR supervisory guidance to support its examiner training courses. However, because NCUA is refining the process, it is too early to evaluate the effect of recent changes. Therefore, we did not determine whether NCUA's IRR policy and procedures have effectively reduced interest rate risk. We plan to revisit this objective later.

Finally, we determined that NCUA may not be effectively capturing IRR when assigning a composite CAMEL[3] rating to a credit union. NCUA currently assesses sensitivity to market risk under the "L" in its CAMEL rating. However, combining sensitivity to market risk with liquidity may understate or obscure instances of high IRR exposure in a credit union. The addition of an "S" rating to its CAMEL Rating System to capture and separately assess a credit union's sensitivity to market risk should improve NCUA's ability to accurately measure and monitor interest rate risk. To better reflect the risk that changes in market rates will adversely affect a credit union's capital and earnings, and in conjunction with a stated goal of NCUA's IRR working group, we are making two recommendations in this report. We recommend NCUA management modify the current CAMEL Rating System by adding an "S" for market risk [S]ensitivity, and revising the "L" rating to reflect only liquidity factors.

We appreciate the cooperation and courtesies NCUA management and staff provided to us during this review.

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[1] We reviewed federally chartered natural person credit unions with assets under $10 billion.
[2] The working group consists of representatives from various divisions within NCUA.
[3] The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset/Liability Management.

BACKGROUND

Loans typically represent a credit union's most significant investment. A credit union may grant unsecured and secured loans. Co-maker loans, share-secured loans, and automobile loans are common types of secured loans. Other types of loans include home equity, residential real estate, member business, line of credit, and guaranteed and insured[4] loans. Although loans may serve as a primary source of income, loans may also pose a major risk to the safety and soundness of a credit union.

Interest rate risk (IRR) is the risk that changes in market interest rates will adversely affect a credit union's capital and earnings, such as its income statement and balance sheet. IRR arises from the following: (1) differences between the timing of rate changes and the timing of cash flows (re-pricing risk); (2) changing rate relationships among different yield curves affecting credit union activities (basis risk); (3) changing rate relationships across the spectrum of maturities (yield curve risk); and (4) interest-related options embedded in credit union products (options risk). A move in interest rates can affect the price of investments, loan portfolio value, and fee income, which are sensitive to interest rate changes.

The Financial Stability Oversight Council[5] addressed the issue of IRR in its 2013 annual report. In the report, the Council stated that established supervisory guidance by the prudential banking and credit union regulators directs financial institutions to have interest rate and credit risk management and measurement systems commensurate with the level and complexity of their risk profiles.

The Council recommended that regulatory agencies and private sector risk managers continue to scrutinize how potential changes in interest rates could adversely affect financial firms' risk profiles. The Council indicated the process should include regular assessments of a financial institution's interest rate and credit risk management strategies, including a thorough assessment of how the institution will perform in a stressed or rapidly changing market environment.[6]

With respect to the credit union industry, credit unions face increased challenges due to historically low interest rates. According to NCUA, although some IRR commonly occurs during financial intermediation,[7] it can negatively affect a credit union's earnings, net worth, net

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[4] Various government agencies guarantee and insure loans. For example, the Federal Housing Administration and the Veterans Administration insure real estate loans; the Federal Insured Student Loan Program insures student loans; and the Small Business Administration guarantees business loans.

[5] Established under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Council provides comprehensive monitoring of the stability of our nation's financial system. The Council is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system. The Council consists of ten voting members and five nonvoting members and brings together the expertise of federal financial regulators, state regulators, and an independent insurance expert appointed by the President. (http://www.treasury.gov/initiatives/fsoc/Pages/home.aspx)

[6] Financial Stability Oversight Council 2013 Annual Report, p 16. (http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2013-Annual-Report.aspx)

[7] Financial institutions act as the intermediary between depositors and borrowers and financial intermediation is the transportation of capital from the depositor to the borrower.

economic value, and the market value of liabilities. Interest rate changes can influence interest-sensitive income and expenses, such as investment income, loan income and share dividends, thereby affecting credit union earnings. Changes in interest rates also may affect the economic value of a credit union's assets and liabilities. In some circumstances, cash flows may change when interest rates change. For example, the continued growth of loans at low fixed rates has contributed to a significant concentration of credit union assets.

Additionally, historically low interest rates could present future risk problems for NCUA. Exposed credit unions without appropriate IRR policies and an effective IRR program pose unacceptable and preventable risks to the National Credit Union Share Insurance Fund (NCUSIF).

NCUA previously issued guidance on asset and liability management (ALM), and IRR management through Letters to Credit Unions (LCU).[8] NCUA believed federally insured credit unions (FICUs), relying on this guidance, adequately managed their IRR. Yet, due to changes in balance sheet composition and increased uncertainty in the financial markets, FICUs experienced increased exposure to IRR. This increase heightened the importance for FICUs to have effective policies and programs explicitly addressing credit union management of controls for IRR. Consequently, NCUA implemented 12 CFR Part 741, Interest Rate Risk Policy and Program, effective September 30, 2012.

NCUA Interest Rate Risk Policy

The IRR rule requires federally insured credit unions with assets greater than $50 million to develop and adopt a written policy regarding IRR management and establish a program to effectively implement that policy. This requirement is part of the credit union's ALM responsibilities. When determining a credit union's insurability, NCUA will consider, among other factors, its IRR policy and implementation program. To assist credit unions, the IRR rule includes guidance on developing an IRR policy and implementing an effective IRR program. NCUA based the guidance on generally recognized best practices for managing IRR, which covers the following areas:

- Oversight and management;
- Measurement and monitoring;
- Internal controls;
- Decision-making; and
- Policy adequacy and program effectiveness.

[8] NCUA conveys specific policies and procedures, compliance, governance, and other timely issues via Letters to Credit Unions and Letters to Federal Credit Unions. See Appendix C for a list of LCUs related to IRR.

In addition, because of the potential risks to the NCUSIF, the IRR rule includes supplementary guidance for large FICUs[9] with complex or high risk balance sheets. This additional guidance convenes the need for enhanced IRR management and internal controls. For example:

- NCUA encourages the responsible credit union officials attain a full understanding of IRR to include the credit union's IRR assessment and potential for changes in IRR exposures;

- Large FICUs should consider increasing the segregation of risk taking and risk assessment duties. For instance, the lending department should not be responsible for monitoring or assessing IRR; and

- Large FICUs must have their financial statements audited annually in accordance with generally accepted accounting standards.

Credit unions with assets over $50 million fall within NCUA's Risk-Focused Examination (RFE) Program. The risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports, as well as on-site work. The RFE process includes reviewing seven categories of risk: Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation. Additionally, the RFE process includes an IRR questionnaire[10] that helps examiners determine the scope of an IRR review. Furthermore, examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up, and (b) analyzing Call Reports[11] and direction of the risks detected in the credit union's operation and management's demonstrated ability to manage those risks.

NCUA examiners may also assess IRR at credit unions not falling under the IRR rule. Because these credit unions are smaller and generally not as complex, NCUA does not require them to have a written IRR policy. However, NCUA does provide IRR guidance and management requirements to smaller credit unions through LCUs and the Office of Small Credit Union Initiatives. Management at one regional office stated the focus at smaller credit unions is more on monitoring IRR trends, recognizing increased IRR, and establishing limits to reduce IRR. In addition, to target the areas of greatest risk for smaller credit unions, NCUA is modifying its Small Credit Union Examination Program (SCUEP) procedures.[12] The new SCUEP defined-scope examination consists of more transaction testing and multi-layered examination procedures that focus on the most pertinent areas of risk in small credit unions such as lending, recordkeeping, and internal control functions. Although, SCUEP examination procedures do not include a review of IRR, if an examiner believes IRR is present, they can request supervisory

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[9] NCUA defines large FICUs as those with assets greater than $500 million.

[10] Completion of the IRR questionnaire is not required if the examiner's initial assessment does not indicate IRR.

[11] Credit unions report financial conditions to NCUA through Call Report Form 5300, commonly referred to as the Call Report.

[12] In 2012, NCUA implemented the SCUEP, which followed the RFE supervision approach, but had different minimum scope requirements. The original SCUEP only applied to small credit unions that were operationally sound and had lower risk CAMEL 1, 2, and 3 ratings. Although NCUA announced SCUEP defined-scope examination during January 2015, field staff will continue to perform RFEs until they receive training on the new SCUEP procedures.

approval to deviate from the examination scope. Credit unions with assets less than $30 million fall under the SCUEP examination.

For credit unions having $30 to $50 million in assets, NCUA regional management has the discretion to choose a SCUEP examination or an RFE examination for credit unions with a composite CAMEL rating of 1, 2, or 3. For credit unions in this asset range with a composite CAMEL rating of 4 or 5, NCUA examiners generally perform an RFE examination.

Interest Rate Risk Performance Goal

As part of its 2015-2016 Annual Performance Plan, NCUA identified the following as an agency priority:

- Developing a proposal for a separate IRR component for complex credit unions' risk based net worth requirement;
- Issuing examiner and industry guidance that introduces revised policy on quantitative risk measurements for IRR;
- Issuing additional supervision guidance on IRR sensitivity methods; and
- Completing an assessment for the addition of an interest rate sensitivity "S" rating to NCUA's CAMEL rating system consistent with other national bank supervisors.

CAMEL Rating System

On November 13, 1979, the Federal Financial Institutions Examination Council (FFIEC)[13] implemented the Uniform Financial Institutions Rating System (UFIRS), commonly referred to as CAMEL. Based on UFIRS, NCUA developed the Early Warning System to assign credit unions an overall rating, eventually adopting the CAMEL Rating System in October 1987. During 1996, FFIEC revised the UFIRS by adding an "S" to CAMEL and on January 1, 1997, FRB, FDIC and OCC began using the CAMELS Rating System.

The CAMELS Rating System generally mirrors the CAMEL components. The additional "S," however, stands for [S]ensitivity to market risk. This component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, examiners should consider the following factors: (1) the ability of management to identify, measure, monitor, and control market risk; (2) the size of the institution; (3) the nature and complexity of an institution's activities; and (4) the adequacy of an institution's capital and

[13] The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions. Regulatory agency members include the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), NCUA, the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB).

earnings in relation to its level of market risk exposure. NCUA currently assesses sensitivity to market risk under the "L" in the CAMEL rating, which stands for liquidity.

Accordingly, NCUA periodically modifies the CAMEL in response to changes within the financial services industry and supervisory policies and procedures. Examiners use the CAMEL Rating System to assign a CAMEL rating to the credit union at the conclusion of an examination. The CAMEL Rating System provides a consistent assessment of a credit union's financial condition and operations. The CAMEL rating includes consideration of key ratios, supporting ratios, and trends. CAMEL ratings range from a 1 (the highest rating) to a 5 (the lowest rating). Credit unions with a composite CAMEL 3 rating exhibit some degree of supervisory concern in one or more of the component areas. Credit unions rated a CAMEL 4 generally exhibit unsafe and unsound practices or conditions, and credit unions rated a CAMEL 5 exhibit extremely unsafe and unsound practices and conditions.

RESULTS IN DETAIL

We determined that NCUA has taken steps to identify and address credit unions with interest rate risk concerns. We also determined that:

1. Regional staff plays an important role in identifying credit unions with elevated IRR and that NCUA examiners use multiple methods to assess and monitor IRR;

2. Examiners are essential in assessing IRR and have various tools to help credit unions address IRR concerns;

3. NCUA established an IRR working group to develop examination-based IRR assessment tools and IRR supervisory guidance to support its examiner training courses. However, because NCUA is refining the process, it is too early to evaluate the effect of recent changes. Therefore, we did not determine whether NCUA's IRR policy and procedures aid in effectively reducing IRR. We plan to revisit this objective later; and

4. NCUA may not be effectively capturing IRR when assigning a composite CAMEL rating to a credit union.

Regional Staff Essential to Identify IRR

We determined that NCUA Regional Capital Market Specialists (RCMS) are pivotal in identifying credit unions with elevated IRR. According to regional management, RCMS conduct annual assessments of credit unions to help prioritize the workload for the upcoming year. In one region, the assessment considers quantitative metrics for IRR, liquidity risk, and investment risk within the region based on comprehensive call report data over multiple years. This assessment compares and contrasts key financial risk indicators, and includes a review of examination contacts. After reviewing the data, RCMS assign a quantitative risk rating and determine the necessary supervision plan for the upcoming year. RCMS analysis may include a review of the following:

- Concentrations in investments with maturities greater than five years;

- Concentrations in fixed rate real estate loans with maturities greater than 15 years;

- Net Worth position and change in position;

- Share volatility and growth rates; and

- Growth ratios in investment and loan portfolios.

In another region, RCMS include any balloon or hybrid loan with interest rates due to readjust after five years in their assessment of real estate concentrations because these types of loans have similar risks as fixed rate loans. RCMS also use a regional developed IRR and liquidity risk model in conjunction with IRR and liquidity risk complexity scoring matrix to identify credit unions exhibiting high liquidity and interest rate risks.

In addition, regional Divisions of Supervision (DOS) also assess and measure IRR. According to management at one regional office, DOS analysts measure IRR on a quarterly basis through an internally developed model called the Broad Spectrum Analysis Report (BSAR). The DOS analyst assigned to each supervisory examiner (SE) group reviews the BSAR results and discusses any unusual findings with the appropriate SE. We learned that the DOS staff for another regional office generates a quarterly report that identifies regional outliers based on key ratios. The staff may use this report during quality control reviews (QCR) and Risk Analysis and Trending Evaluation (RATE) reviews[14] to help identify the existence of IRR. These QCRs also include a review of the credit union's IRR profile.

Multiple Methods Used to Assess, Monitor and Mitigate IRR

We determined that NCUA examiners use multiple methods to assess and monitor IRR through onsite examinations and contacts, and offsite supervision. For instance, at each credit union reviewed, we found that examiners conducted a preliminary risk assessment, which included a review of IRR. According to the National Supervision Policy Manual (NSPM), the assessments drive the scope of the examination, which forces examiners to focus on current and emerging risk indicators, and evaluate preliminary risks. During this process, the NSPM requires examiners to review the following:

- The previous examination;
- The most recent financial performance report (FPR) and any adverse financial trends in key areas, significant changes in the balance sheet structure, significant growth patterns, and significant changes in loan, investment, or share products;
- Areas of risk triggered by the most recent national and/or regional risk reports for the associated credit union; and
- Outstanding administrative action(s).

Moreover, according to regional management, examiners measure and monitor IRR throughout the examination process. For instance, during an IRR assessment examiners review credit union policy and procedures to ensure that the credit union has established and implemented an IRR management program that complies with the IRR rule. Additionally, even if the IRR rule does not apply, according to NCUA guidance, examiners should ensure a credit union's IRR management process corresponds to the size and complexity of credit union.

[14] RATE reviews help identify developing trends and allow field staff to adjust supervision plans accordingly.

We determined that examiners reviewed the IRR policy during their examinations of the five credit unions we selected and noted policy concerns at four. We also determined that in the five examinations we reviewed that examiners performed the following tasks:

- IRR analysis and trending;
- ALM analysis and stress testing;
- Modeling[15] assumption reviews;
- Net Economic Valuation volatility assessment reviews;
- Net Interest Income simulation reviews; and
- Real Estate Loans and Investments reviews.

According to regional management, examiners are required to evaluate the reasonableness of the results and increase the exam scope as necessary. Examiners are also required to identify and comment on any IRR-related triggers or trends, which also may result in changes to supervision or examination team participants. For challenging IRR and investment issues, examiners may initially obtain the support of a Capital Markets Subject Matter Examiner.[16] However, examiners may also seek assistance from an RCMS for clarification on more complex IRR situations. We determined that RCMS assisted examiners during the five examinations we reviewed. During our review of examination work papers, we found instances where the RCMS helped the examiners identify different types of supervisory concerns. For example, RCMS and the examiners found that:

- Real estate loan and investment portfolio contributed to high IRR;
- IRR policy concerns existed;
- Modeling results were questionable; and
- Low net worth was the primary reason for high IRR.

In addition, regional management stated that examiners perform offsite monitoring of credit unions in accordance with the NSPM, which included pre-exam planning and scoping, and

[15] Modeling is a tool that converts inputs into quantitative estimates using a mathematical and statistical process and applies statistical, economic and financial theories. Inputs can be qualitative or based on expert judgment, as long as output is quantitative.
[16] A subject matter examiner has in-depth knowledge and experience in a particular focus area and helps expand the knowledge base of generalist examiners.

reviewing monthly financial statements. Regional management also stated that in accordance with the NSPM, on a quarterly basis, examiners are required to:

- Complete RATE reviews, which includes a thorough review of applicable FPRs and risk report triggers; and

- Validate Call Reports, which includes identifying any significant growth in credit union products that could increase IRR.

We determined that examiners have multiple tools that are essential when assessing a credit union's IRR. According to regional management, examiners may work with credit union management to assist them in understanding the factors that increase a credit union's IRR and to provide guidance on ways to improve monitoring of IRR. Examiners and credit union management may also discuss the reasonableness of limits established to control IRR that management included in their policies.

In addition, examiners assess credit union management's ability to effectively: (1) measure, identify, monitor, and control the credit union's IRR exposure; and (2) implement corrective action that addresses the deficiency and mitigates risk. We determined that examiners addressed minor weaknesses through Examiner's Findings[17] and obtained credit union management's concurrence to resolve the issue. For significant deficiencies, we noted examiners used the Document of Resolution (DOR)[18] to outline plans and agreements reached with credit union officials to reduce identified areas of unacceptable risk.

At the five credit unions reviewed, we determined that examiners issued Examiner's Findings and/or DOR items to address IRR concerns. For example, at one credit union, the examiner determined that IRR monitoring was not adequate for the level of risk inherent in the balance sheet structure. The examiner believed this was a minor weakness and used the Examiner's Findings to address the issue. However, the examiner also had a major concern with credit union management's inadequate oversight, tracking, monitoring, and reporting of IRR and issued a DOR item accordingly. At another credit union, we determined that the examiner issued DOR items to address IRR concerns within the investment portfolio and IRR measurement issues.

Action Taken to Better Identify Credit Unions with IRR Concerns

We determined that NCUA has taken steps and intends to take further action to improve the identification of credit unions with IRR concerns. During risk-focused examinations, the NSPM requires examiners to review the seven areas of risk and assess credit union management's ability to manage those risks. Consequently, the current examination scoping tools capture only general risk exposures.

[17] Examiner's Findings include less urgent problems that the credit union must address, but can do so in the normal course of business. Management may use its own discretion to determine a reasonable timeframe and approach for correcting these issues. If necessary, examiners may provide corrective action plans.

[18] The DOR identifies persons responsible and timeframes for correction. A DOR may contain one or more DOR action items. An action item is the corrective action credit union management must perform. Credit union management must also address an examiner's concerns related to a specific risk area and risk factor.

To specifically assess and address IRR, NCUA created an IRR working group. One of the goals of the working group is to determine a method for the systemic collection of IRR data from credit unions. To that end, the working group recently conducted a specialized series of IRR reviews (IRR Sweep). The working group conducted the IRR Sweep in two phases using data from credit union ALM reports received from regional offices.

The IRR Sweep did not include the examiners' assessment of credit union management's ability to effectively measure, identify, monitor, and control IRR exposure. During an examination, examiners collect, analyze and interpret data; consequently, their judgment affects the overall analytical process. Because the IRR Sweep focused on the quantitative aspects of IRR, the working group's resulting analysis concluded there was a higher amount of IRR at a significant number of credit unions where examiners had previously given those same credit unions a lower IRR rating during regular supervision examinations. The working group indicated that possible reasons for the higher amount of IRR could be due to:

- Favorable assessment by the examiner of the IRR management program may have influenced the overall assessment of IRR; and

- Modeling assumptions (asset modeling, non-maturity shares) may have distorted the view of risk exposure.

Currently, the working group is developing examination-based IRR review tools to refine the evaluation of a credit union's current and prospective IRR exposure. In addition, NCUA has redesigned its examiner training courses to include material on IRR. For example, NCUA modified its New Examiner core training courses to emphasize IRR concepts, IRR exam steps and procedures, and the application of IRR principles. NCUA also created a Principle Examiner course to facilitate a more in-depth understanding of key IRR modeling components.

Since NCUA is in the process of implementing changes to IRR assessment, it is too early to determine the effect of such changes. As a result, we did not determine whether NCUA's IRR policy and procedures help to effectively reduce IRR. Therefore, we intend to revisit this objective at a later date.

Adding the "S" to the CAMEL Rating May More Effectively Capture IRR

We determined that NCUA may not be effectively capturing IRR when assigning a composite CAMEL rating to a credit union. This occurs because NCUA assesses sensitivity to market risk and liquidity under the "L" in the CAMEL Rating System, which according to the IRR working group, may understate or obscure instances of high IRR exposure in a credit union. As a result, examiners may not accurately reflect the degree of IRR under the "L" component when assigning the CAMEL rating to a credit union.

According to the working group, IRR exposure has steadily increased within the credit union system and now represents an elevated potential threat to earnings and capital for some institutions. To help identify elevated IRR, the FRB, FDIC, and OCC assess sensitivity to market risk under the "S" in the CAMELS Rating System. We learned during our review that

E&I assessed the impact of adding the "S" to the CAMEL Rating System. As previously discussed, the IRR Sweep showed that a number of credit unions had seemingly elevated IRR. Yet, during regular examinations, examiners had rated these same credit unions lower for IRR. By adding the "S" component, we agree with the working group that NCUA could enhance its risk analysis of IRR and improve its ability to estimate and monitor IRR.

Moreover, through interviews with regional management, we determined that a separate rating for liquidity and sensitivity to market risk would provide additional clarity on ratings for management and officials, and facilitate better supervision of IRR. Currently, a credit union with high IRR and low liquidity risk is difficult to rate given that, per agency policy, the "L" definition blends both market risk and liquidity factors. Furthermore, for state-chartered credit unions where the state supervisory authority[19] has adopted the CAMELS Rating System, we learned from regional management that credit union management has been supportive of the additional "S" rating.

We also determined that situations arise where liquidity and interest rate risks deserve different ratings. In such circumstances, the addition of the "S" rating will prove beneficial to both examiners and credit unions. According to regional management, separate ratings would enhance the level of detail when reviewing liquidity and interest rate risk. This, in return, would allow examiners to accurately emphasize the area that is higher risk and in need of greater improvement. It may also assist credit unions in improving their risk identification and subsequently management of liquidity risk and IRR.

As previously mentioned, we determined that E&I, in line with NCUA's performance plan, assessed the impact of adding the "S" to NCUA's CAMEL Rating System. Specifically, E&I concluded that by adopting the CAMELS Rating System, NCUA would:

- Increase clarity and transparency surrounding IRR exposure;
- Improve its ability to monitor and forecast IRR through enhanced risk analysis;
- Increase the accuracy of the IRR rating;
- Improve resource allocation;
- Improve communication and monitoring of IRR; and
- Provide consistency with the other federal agencies that have adopted CAMELS.

According to E&I, changing to a CAMELS Rating System would require NCUA to modify applicable databases, update supervisory guidance, and conduct employee training, but would not present a regulatory burden on credit unions. E&I estimated that these modifications would cost approximately $300,000 to $425,000. We determined that as of December 2014, there were 6,273 federally insured credit unions with combined assets totaling over $1.1 trillion. Given the

[19] A state supervisory authority is primarily responsible for the supervision of federally insured state-chartered credit unions; however, NCUA is responsible for ensuring the safety of the National Credit Union Share Insurance Fund.

large volume of assets, we believe that with projected costs of less than $500,000, the benefits of modifying the CAMEL Rating System far outweigh the potential expenses. Therefore, we are making the following recommendations to NCUA management.

Recommendations:

We recommend that NCUA management:

1. Modify NCUA's CAMEL Rating System by developing an "S" rating to better capture a credit union's sensitivity to market risk and to improve interest rate risk clarity and transparency.

2. Revise the current "L" in NCUA's CAMEL Rating System to reflect only liquidity factors.

Management Response:

Management agreed with both recommendations and committed to submitting a proposal for regulatory change to the NCUA Board by the end of September 2016. Because the process involves regulation changes, reprogramming of multiple data systems, and revisions to examination policies and procedures, management anticipates final implementation by the end of 2018. Management also indicated that implementation of Recommendation 2 will track with the addition of an "S" rating, which will require revisions to the guidance for assigning the "L" component to remove IRR references.

OIG Response:

We agree with management's planned actions.

Appendix A. Objective, Scope, and Methodology

The objectives of this audit were to determine: (1) whether NCUA's IRR policy and procedures help to effectively reduce interest rate risk and (2) what action NCUA has taken or plans to take to identify and address credit unions with interest rate risk concerns.

To accomplish our objective, we interviewed NCUA headquarters and regional management and staff. We obtained and reviewed NCUA guidance, policies, procedures, and other available information addressing IRR. We also judgmentally selected five credit unions (one from each of NCUA's five regions) and analyzed the corresponding examination and supervision reports and related documents.

We conducted this review from February 2015 through November 2015 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We used computer-processed data from NCUA's AIRES and NCUA Online systems. We did not test controls over these systems; however, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Furthermore, we provided NCUA management officials a discussion draft of this report and included their comments where appropriate.

Prior Audit Coverage

NCUA OIG has not conducted any prior audits within the past five years related to this subject.

Appendix B: NCUA Management Response

National Credit Union Administration
Office of Executive Directc⁻

SENT BY EMAIL

TO: Inspector General Jim Hagen

FROM: Executive Director Mark Treichel Mark Treichel

SUBJ: Audit of NCUA's Interest Rate Risk Program

DATE: November 10, 2015

The following is our response to the recommendations set forth in the Office of Inspector General's report titled *Review of the National Credit Union Administration's Interest Rate Risk Program.* The development and improvement of the agency's Interest Rate Risk (IRR) supervision program remains a high priority for NCUA and we concur with the report recommendations. Below are more detailed responses to each of the recommendations.

OIG Report Recommendation #1
Modify NCUA's CAMEL Rating System by developing an "S" rating to better capture a credit union's sensitivity to market risk and to improve interest rate risk clarity and transparency.

Response: We agree with the recommendation and commit to presenting a proposal on changing the regulation to the NCUA Board by the end of Q3 2016. If the Board approves the regulatory change, we target final implementation by the end of 2018. While progress has been made in assessing changes required in NCUA's systems, procedures, and examination guidance to add an "S" component, the change process will be complex. It involves regulatory changes followed by reprogramming multiple IT systems, data storage and retrieval, and revising examination policies and procedures. The largest change comes in the AIRES examination system which is scheduled for a rewrite that will carry into 2018.

OIG Report Recommendation #2
Revise the current "L" in NCUA's CAMEL Rating System to reflect only liquidity factors.

Response: We agree with the recommendation and the changes will track with the addition of the "S" rating. The separation of liquidity and interest rate risk, currently combined under the "L" component, would require revisions to the guidance for assigning an "L" component to remove IRR references. Additionally, staff would review other potential revisions to C, A, M and E that might be appropriate in conjunction with this change.

Thank you for the opportunity to review and comment on the report. If you have any questions, please do not hesitate to contact my office.

cc: E&I Director Fazio
Deputy Executive Director Kutchey

1775 Duke Street – Alexandria, VA 22314-3428 – 703-518-6320

Appendix C: NCUA Letters to Credit Unions Related to Interest Rate Risk

Letters to Credit Unions Related to Interest Rate Risk			
Month Issued	LCU Number	Title	Summary
May 2010	10-CU-06	*Interagency Advisory on Interest Rate Risk Management*	Includes FFIEC's Interagency Advisory on Interest Rate Risk Management, which reminds institutions of supervisory expectation for sound practices to manage IRR.
September 2003	03-CU-15	*Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios*	Reminds credit unions of the importance of effective IRR management over the real estate mortgage portfolio. It notes the potential risks associated with rising interest rates and a mortgage portfolio containing a high concentration of fixed rate loans granted during the period when interest rates were historically low.
July 2003	03-CU-11	*Non-Maturity Shares and Balance Sheet Risk*	Provides guidance on sound practices for understanding and evaluating the behavior of non-maturity shares in the context of managing risk, particularly interest rate and liquidity risk. It suggests that, as a best practice, credit unions take necessary steps to measure, monitor, and control interest rate and liquidity risks that could evolve when rates rise and the economic climate improves.
May 2002	02-FCU-09	*Risk-Focused Examination Program*	Introduces the RFE program and defines the seven risk areas, one of which is IRR. NCUA indicated that the RFE would be an improvement over the previous examination program because examiners would concentrate on areas of risk, risk mitigation, and the credit union's ability to identify and adapt to changing conditions.
October 2001	01-CU-19	*Managing Share Inflows in Uncertain Times*	Advises that as a result of the events occurring on September 11, 2001, credit unions may experience an unexpected inflow of funds, which coupled with the effects of slower economic growth, may result in the dilution of earnings and capital in the short term. Credit unions should exercise diligent management practices as they analyze available options and objectives in managing potential increased inflow of funds.
July 2001	01-CU-08	*Liability Management - Highly Rate-Sensitive and Volatile Funding Sources*	Emphasizes the importance of managing risk within a total balance sheet perspective, while focusing on the funding side of ALM.
August 1999	99-CU-12	*Real Estate Lending and Balance Sheet Risk Management*	Emphasizes the importance of interest rate risk management, while focusing on mortgage-related assets because they are generally a long-term asset type and also have dynamic cash flow characteristics.

Appendix D: Acronyms and Abbreviations

ALM	Asset Liability Management
BSAR	Broad Spectrum Analysis Report
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management
CAMELS	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, [L]iquidity, and [S]ensitivity
DOR	Document of Resolution
DOS	Divisions of Supervision
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FICU	Federally Insured Credit Union
FPR	Financial Performance Report
IRR	Interest Rate Risk
LCU	Letter to Credit Unions
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NSPM	National Supervision Policy Manual
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
QCR	Quality Control Review
RATE	Risk Analysis and Trending Evaluation
RCMS	Regional Capital Market Specialists
RFE	Risk-Focused Examination
SCUEP	Small Credit Union Examination Program
SE	Supervisory Examiner
UFIRS	Uniform Financial Institutions Rating System