The NEV Supervisory Test "Perfect Storm"

Independent observations from DCG's work with high-performing credit unions

Keri Crooks, Managing Director
Darling Consulting Group

The rise in market rates during 2022 has created an environment warmly welcomed by financial institutions. Interest rates have moved upward across the entire yield curve, discounted bond opportunities abound, loan rates are improving, and non-maturity deposit costs on average have been unchanged. Balance sheet models built on financials as of March and April 2022 indicate that net interest income, balance sheet spread, Net Economic Value analysis with mathematically-based core deposit assumptions, and net worth have improved meaningfully. The yield curve is helping us, finally.

However, in direct conflict with these and other positive trending financial risk management metrics, the NCUA's NEV Supervisory Test results suggest widespread elevated levels of risk across the industry and a growing list of credit unions moving toward "Extreme Risk."

As of March 31st, a meaningful number of credit unions have shifted into the NCUA's risk classifications of "High" and "Extreme" risk. Further, consider that the FOMC has increased the fed funds rate by 125bps and medium/long term US treasury rates are on average 100bps higher since March 31. This will undoubtedly place additional downward pressure on asset valuations in the NEV analysis.

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Given that market rates have increased, asset values are notably lower. In today's Base NEV models, asset values now resemble last quarter's market value (MV) estimate for the +200bp shock and asset values in today's +300bp shock resemble last quarter's estimates for the +500bp shock. Meanwhile, NMD MV estimates are still the same(!!!), reflecting the NCUA standardized 1% premium in the current base and 5% premium in the +300 shock.

While the Supervisory Test may classify a credit union as "low" to "moderate" risk for March 31st, analysis reveals that the current yield curve will produce results that push institutions towards a higher elevated level of risk classification. And, if a credit union is classified as "High Risk" (or even on the lower end of "Moderate"), there is a high probability that "Extreme" will be its next risk classification.

Currently, credit unions that fall within the Extreme Risk classification are being told by field examiners that this automatically triggers a Document of Resolution (DOR) for de-risking. Examiners are referencing the 2016 *Letter to Credit Unions 16-08 - Interest Rate Risk*, which states: "***The new "extreme" risk level category represents an interest rate risk level that is categorically unsafe and unsound****. A credit union with an "extreme" interest rate risk level is considered unacceptable and would need to take appropriate de-risking actions."*

To reiterate, regardless of the improvements to the real world financial conditions of credit union balance sheets (income and risk metrics), this singular standard isolated Supervisory Test and resulting risk classification can be cause for an "unsafe and unsound" designation and require a "de-risking" plan.

Baffling, but real.

The result? Unfortunately, these de-risking plans are doing the exact opposite of their intention: they are adding real risk by encouraging credit unions to disconnect from their communities. Corrective action often includes contracting loans by becoming less competitive for longer-term MBLs, and/or becoming less active in the housing market through community mortgage origination and servicing. Worse, corrective action could also influence a credit union to curb share growth or even allow deposit dollars to leave the institution.

The Key Issue to Understand and Push for Change at the NCUA

This widespread downgrade in risk classifications is very seldom the result of increased/longer asset durations. In fact, DCG's models suggest that while mildly longer, the total asset duration for most credit

unions has remained consistently at or below three years from 2020 to 2022. Moreover, Net Worth Ratios have remained fairly consistent as well, highlighting that the drop in 0-shock NEV ratios is NOT typically the result of increased balance sheet leverage on the part of credit unions.

We may conclude that the ONLY meaningful influences on these negative trends in Supervisory Test results are the standardized assumptions for NMD premiums and higher market rate levels. Neither of these variables can be controlled by credit unions themselves.

Background

The Net Economic Value Supervisory Test became effective on January 1, 2017 and was announced in a Letter to Credit Union in October of 2016 (16-CU-08 Revised Interest Rate Risk Supervision).

Within this letter are a Fact Sheet and other supporting documents that provide details for "*the process in which the NCUA will periodically evaluate the Net Economic Value Supervisory Test parameters, validate the underlying assumptions, ensure the test is reasonable and effective, and review the new risk classification.*"

In fact, that guidance document clearly states that "*The Net Economic Value Supervisory Test aligns our supervision capabilities with emerging risk exposures and ensures we remain abreast of changes in credit union portfolios and the market conditions.*"

Furthermore, "*We expect to review the Net Economic Value Supervisory Test and Estimated Net Economic Value Tool parameters over time to address changes in market conditions and potential shifts in credit union risk profiles*."

Lastly, "*NCUA will also periodically assess the risk classifications for low, moderate, high, and extreme interest rate risk (as expressed by post-shock net economic value ratios and base-to-shock sensitivity changes) to ensure appropriate measurement values*."

Repealing the DOR mandate appears to be the simplest area to promote change. In the examination guide, examiners are required to review a broad array of interest rate risk models and metrics, and credit unions are required to conduct a Core Deposit Study to assess pricing and liquidity sensitivities. Meanwhile, the Supervisory Test definition for "Extreme Risk" renders all of these other tools irrelevant in determining the "S" rating.

It is important to state that removing the DOR mandate and redefining the “Extreme Risk” classification does not remove the merit of issuing DORs where such action appears more warranted (declining income, diminished liquidity, increased asset quality problems, etc.). It merely helps avoid an unwarranted broad characterization of a credit union (e.g., categorically unsafe and unsound) when most risk management metrics aside from the Supervisory Test categorically dispute that characterization. It also helps the NCUA avoid spreading itself too thin in redirecting resources from credit unions that do in fact demand more attention due to more significant risk management deficiencies and poor financial conditions.

The NCUA has clearly been working to align more deliberately with Interagency Regulatory Guidance (FDIC, OCC, and FRB) on risk management. Just in the past two years, our industry has witnessed the implementation of Risk Based Capital Ratio and the new “S” rating that better distinguishes liquidity risks from interest rate risk. Since the financial crisis of 2008, banking regulators have transitioned to place less emphasis on the NEV model and increase their bias to broader stress modeling on income and credit, a direct result of the mistakes made from forced asset liquidations that the industry took years to recover from.

Further, where the NEV model is required and reviewed, there is a strong emphasis on quantifying and qualifying assumptions for non-maturity deposits for the individual bank. **This Net Economic Value Supervisory Test with standard assumptions for deposit premiums does not exist for a single bank, regardless of capital structure (mutual, Sub S, public, or holding company). Ironically, for both credit unions and banks, NEV models that use more realistic deposit assumptions, NEV and NEV ratios are all following an increasing/improving trend with increased core deposit premiums.** The Supervisory Test is ultimately a one size-fits all approach that trivializes the real value of deposits and does not apply outside of credit unions.

In the absence of regulatory change, credit unions should be prepared for the possibility of a DOR and “De-Risk” mandate. It is wiser to be safe (i.e., proactive) than sorry (i.e., reactive) in this situation.

Five Action Steps for Credit Unions to Take Today

1) ***Contribute to the Growing Calls for Change: “Extreme Risk” Definition and De-Risk Mandate***

These Supervisory Test issues are not going unnoticed. ALCO vendors like Darling Consulting Group and trade organizations are acting as agents of change for the credit union industry. DCG has taken the

position that more voices are more powerful than a single powerful voice. To this end, credit unions should consider:

- Writing to their state legislatures
- Contacting local or regional trade organizations
- Highlighting concerns to field and regional exam offices

As the number of credit unions classified as "Extreme Risk" grows, the greater potential for systemic risks develops, creating loss in confidence and undue liquidity exposure to the credit union industry. It has been six years since implementation, with a full economic rate cycle behind us to review, assess, and identify the Test's shortcomings. We are now operating through our second rising rate cycle since 2016, with greater risk that a larger majority of credit unions will be classified as "Extreme Risk." The manner in which the NCUA uses and administers this tool must change NOW before it is too late.

2) Be Prepared: Understand Full Risk Position with Comprehensive Analysis, but Concise Documentation

Never challenge an examiner without having a well-documented outline of analysis that supports the credit union's viewpoint and perspective on its financial risk position. As it relates to market risk, creating a strong defense includes linking interest rate sensitivities to a liquidity position (collateral values, estimated sales gains/losses, cash flows, etc.) and potential credit exposures. Quantifying an institution's ability to absorb risk/exposure through stress testing is key to convincing anyone that the credit union is not operating in an unsafe and unsound manner. The ability to discuss these issues with examiners and/or state the case to a Board depends on how well they digest defense arguments. In this regard, try to be concise in presentation materials.

3) *Educate the Board*

Being presented with a DOR is never a pleasant experience for the Board or management. However, the ability to manage through the situation and focus the narrative on what the true business issues and most reasonable options for corrective action are may be determined by the degree to which the Board is educated on all these things. The less educated a Board is on the issues, the less likely they will be confident in supporting a defense strategy – and the more likely they will be submissive to examiner perspectives.

4) Understand the Full Scope of Corrective Action Options to "De-Risk"

DCG has observed that the NCUA typically requires that a credit union correct an "Extreme Risk" situation within 12-18 months, preferring sharp and quick solutions. Often this leads to the sale of fixed rate assets and/or balance sheet shrinkage. These are both very costly strategies. While they may provide a quick boost to the Net Worth Ratio, a significant drop in equity surplus with a long recovery or pay-back period usually results.

A credit union put in a position to act on strategy that it would not otherwise consider – or to fix a problem it doesn't believe is a problem – would be wise to examine all of its alternatives to ensure that it does not cost the institution more income and capital than necessary. This requires extension modeling and documentation as well as additional education at the management and/or Board level.

While it may lengthen the resolution period, do not undermine the merit of taking a more calculated approach like cash flow redeployment or controlled asset growth: strategies that allow earnings to strengthen capital over time without placing pressure on the Net Worth ratio denominator (total assets).

Among other alternatives, interest rate hedging instruments are now viewed by regulators as wise and viable tools. Credit unions should no longer fear criticism for employing plain vanilla interest rate swaps, caps, and floors to help manage interest rate risk.

A close examination of the potential role of secondary capital in support of a long-term growth plan might even be a worthwhile consideration.

5) Understand the Appeals Process

In the event that a credit union experiences conduct that the exam team deems unacceptable and/or a De-Risk Plan is not accepted, be aware that it has the right to submit an appeal of the examiner findings and conclusions. Before taking this action, it is important to note that examiners are required to issue a DOR and a De-Risk mandate in the event of an "Extreme Risk" classification on the Supervisory Test. In this regard, an appeal should focus on the methods used for corrective action rather than the merits of whether corrective action is warranted. Also, consider longer-term implications for the relationship with the local field or regional office examiners. It would be unwise to issue an appeal in the hopes of making a point to the exam team and/or the issue, if resolved, does not meaningfully change the situation.

Avoiding Unintended Consequences

The DCG mantra is "Listen to Your Balance Sheet." Unfortunately, early signs indicate that high-performing, safe, and sound credit unions are being **required to do the opposite of what their balance sheet position is telling them**. This will effectively lead to lower earnings, greater exposure and unpreparedness to the next economic downturn/lower rates, and a reduced ability to grow and serve members, employees, and communities.

If the Supervisory Test must remain a part of the risk management landscape for credit unions, it would be a welcome event if the definition of "Extreme Risk" were modified and the DOR mandate lifted to provide greater room for the examination team's judgment. The original intent of the Supervisory test was to provide a scoping tool to examiners; the credit union community should encourage the NCUA to reassess how well it is meeting that objective. Otherwise, the unintended consequences could be dire.

If you have questions about the NEV Supervisory Test, please reach out to your DCG advisory consultant.

Keri Crooks, Managing Director
Darling Consulting Group

Keri Crooks joined the DCG team in 2002. She consults with ALCO groups and boards of directors at banks and credit unions in the area of asset liability management with the goal of enhancing high-performing institutions. She takes a hands-on approach at developing strategies to best fit the risk profile for each institution's balance sheet, while also balancing trends and pressures alive in the industry today.

Additionally, Keri remains actively involved in advancing Liquidity360°®, DCG's proprietary liquidity risk management software, and is a frequent author on balance sheet management topics.

Keri received a B.S. in business administration/finance from the University of Massachusetts at Lowell and currently resides in southern New Hampshire with her family.

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