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Putting the "S" on CAMELS

NCUA Sharpens its focus on IRR and Liquidity

By Mark Cary
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On April 2, 2022, the NCUA released a new rule, found in *NCUA Letter to Credit Unions (Letter No: 22-CU-05)* to its CAMEL regulatory requirements. The regulator that the NCUA will add *Sensitivity to Market Risk* — represented by the letter S — to its CAMEL examination framework. In addition, the NCUA redefined the Liquidity Risk or "L" component of the CAMEL rating. The final rule became effective April 1, 2022. In this article, we'll examine what led to this new release, where mortgage loans fit into this targeted release and how credit unions can get prepared for their next examination in light of this new release.

BACKGROUND AND REASON FOR ADDING THE "S"

The CAMEL regulatory framework has been in place and has provided the major tenants of a safety and soundness examination since 1997. According to the Federal Register summary, "the benefits of adding the S component are to enhance transparency and to allow the NCUA and federally insured natural person and corporate credit unions to better distinguish between Liquidity Risk ("L") and Sensitivity to Market Risk ("S"). The addition also enhances the consistency between supervision of credit unions and financial institutions supervised by other banking agencies."

If you dig into the Federal Register release, you'll also see hints of another reason they are making this change, an increased Interest Rate Risk profile of credit unions. When referring back to the original CAMEL framework introduction in 1997, the NCUA noted that, since 1997, the credit union industry has increased its holdings in mortgage related assets from 19% in 1997 to 45% in June 2021.

RUMBLINGS BENEATH THE SURFACE

While the release from the NCUA seems to indicate that the regulator has already been evaluating credit unions from a sensitivity-to-market-risk perspective, we believe the increase in mortgage related assets and the pandemic-induced artificially low mortgage rates has given examiners increased concern that may have been the last coal on the fire to prompt adding the "S". By examining the trend of fixed rate mortgages with terms >15 years and at the same time evaluating the trend of the average loan yield, we see an alarming pattern and the advent of the super-low, long-term fixed rate mortgage. These mortgages reached an all-time high during the months following the pandemic due to record refinance activity, and in many cases we've seen credit union portfolios that have almost completely turned over and have significantly higher interest rate risk as a result.

FIXED RATE MORTGAGES REACH NEW PANDEMIC-ERA HIGHS

Chart 1 below is the percent of fixed rate mortgages with terms > 15 years as a percent of loans for all U.S. credit unions. The second chart shows the average interest on loans for all U.S. credit unions. The issue that is concerning to regulators has to do with the level of longer-term, lower-coupon fixed rate mortgages that have been added to the balance sheet of many credit unions over the past several years.

INTEREST ON LOANS TO AVERAGE ASSETS NEARS ALL-TIME LOW

Chart 2 below illustrates the decline in the interest rates on loans following the COVID-19 pandemic.

PEELING BACK THE ONION LAYERS

Just like many restaurant onion appetizers, as you peel away the layers, what's left is just not that appetizing.

Through analysis of a significant number of mortgage portfolios, we've been able to zero-in on Interest Rate Risk within the mortgage portfolio and attribute the majority of the risk to 20% of an institution's most rate-sensitive loans. Unfortunately in some cases, there are institutions that have an alarming percentage — as much as 60% — in these IRR heavy fixed-rate mortgages. And that's a major concern to regulators.

For purposes of evaluating the most rate-sensitive fixed-rate mortgages in the portfolio, segmenting the loans into buckets based on coupon bands and maturity bands enables us to isolate those loans that have the longest maturity and the lowest coupon, which we refer to as "Long-Lows". Chart 3 (next page) is an example of how this is done using maturities across the columns and coupons down the rows.

Maturities are separated into short (<120) medium (120-180) and long (>180), while coupon bands are separated by low (<5%), mid (5%-6%) and high (>6%). For periods of abnormally low rates, such as the periods following the financial crisis of 2007-2008 and the pandemic of 2020, you should also further stratify the low coupon band. For example, for the longest maturity box, we could further isolate the coupons into low (<4%), mid (4%-4.49%) and high (4.5%-4.99%).

Pointing back to the 80/20 rule mentioned earlier, the most concerning segment of the fixed rate portfolio is the one with loans that have a rate below 4%. What we've observed during the period after the COVID-19 pandemic, when mortgage rates hit an all-time low, are that many portfolios began to see inordinate amounts of loans with rates of less than 3.0%. This is problematic because the price volatility in an up-100-basis-points scenario was approaching 8 points in losses and in an up 300 basis points scenario exceeding 20 points.

As we evaluate portfolios of all sizes and all institution types, what we observed was an alarming increase in interest rate risk within the fixed rate mortgage portfolios of credit unions as well as banks.

CHART 1: U.S. CREDIT UNIONS FIXED RATE 1ST MORTGAGES > 15 YEAR

Source: S&P Global Market Intelligence

CHART 2: U.S. CREDIT UNIONS INTEREST ON LOANS/AVG. ASSETS

Source: S&P Global Market Intelligence

CHART 3: LONG LOWS BY COUPON BAND

COUPON RANGE (%)	CALC. TERM TO MATURITY (MONTHS)	"SHORT" BELOW 120	"MEDIUM" 120 - 180	"LONG" Over 180	TOTALS
	"LOW" BELOW 5.00%	6,015,063 3.93% 89 105.00% 2&	117,335,819 3.80% 172 105.15% 2: &	**474,823,881** **4.05%** **320** **103.07%** **89&**	598,174,764 4.00% 288 103.49% 98%
	"MID" 5.00 - 6.00%	1,207,745 5.57% 93 99.63% 1&	1,389,000 5.24% 163 104.29% 1&	6,864,344 5.62% 327 107.86% 2&	9,461,090 5.56% 273 106.28% 2%
	"HIGH" Over 6.00%	1,541,808 7.72% 80 96.17% 0%	0 0.00% - 0.00% 0%	909,323 6.07% 320 108.12% 0%	2,451,131 7.11% 169 100.60% 0%
	TOTALS	8,764,616 4.82% 88 102.71% 2&	118,724,820 3.82% 172 105.14% 2: &	482,597,548 4.08% 320 103.14% 8: &	610,086,984 4.04% 288 103.53% 211&

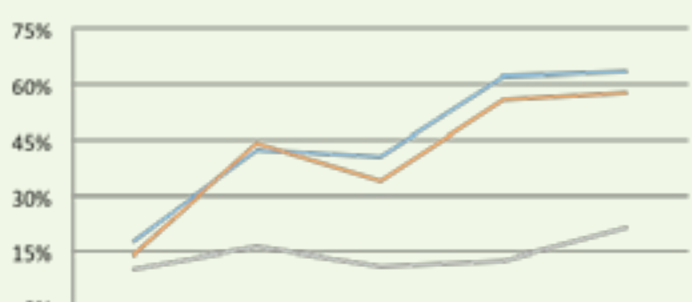
LONG LOWS BY COUPON BAND	
BELOW 4.00%	222,398,008 3.68% 297 102.11% 47%
4.00 - 4.49%	143,041,025 4.17% 332 103.40% 30%
4.50 - 4.99%	109,384,847 4.64% 350 104.57% 23%

Source: FHN Financial Capital Assets Corp

Chart 4 shows the increase in fixed rates as well as the increase in "Long-Lows" nationwide from 2018-2021.

CHART 4: LONG LOWS 2018-2021

Growth Rate of Long Low Box



	2018 Q4	2019 Q4	2020 Q4	2021 Q4	2021 Q1
Example	17.5%	42.1%	40.3%	62.1%	63.2%
Peer Group	13.9%	44.3%	34.0%	55.9%	57.9%
All Portfolios	10.3%	16.4%	11.0%	12.7%	21.4%

Source: FHN Financial Capital Assets Corp

Because we're able to see portfolio changes on a quarterly and sometimes monthly basis, we could see first-hand the impact that artificially low rates had on portfolios. And because many balance sheets are examined by regulators long after a significant change occurs, the turnover in the portfolio can be rapid and severe before management or regulatory examiners realizes what's happened.

Given this rapid change in the makeup of mortgage portfolios, we were not surprised to see the new Letter to CUs adding Sensitivity to Market Risk ("S") to its CAMEL regulatory framework. It's almost as if the "warning label" (adding the S component) was added to the mortgage portfolios after a problem already existed.

HOW RISKS WITHIN MORTGAGES CAN BE IDENTIFIED, MEASURED AND MONITORED FOR IRR AND LIQUIDITY RISK

As explained in the Federal Register and the accompanying Appendix A to Letter No: 22-CU-05, the new Sensitivity to Market Risk ratings will be based on, but not limited to, the following evaluation factors:

- Sensitivity of a credit union's current and future earnings and economic value of capital to adverse changes in market prices and interest rates;
- Management's ability to identify, measure, monitor and control exposure to market risk considering a credit union's size, complexity, and risk profile; and
- The nature and complexity of interest rate risk exposure.

With the above in mind, and the impact of the post-pandemic low-rate period, institutions need to evaluate their mortgages on a more granular level and determine where to draw the line in the sand on low-rate, long-term mortgages.

Many of these loans will have thin to negative margins. It's an issue that can cause concern for another CAMEL framework letter — E for Earnings.

For some institutions, the interest rate risk scale has already tipped too far and corrective action will likely be necessary.

That action can include the following:

1. No longer originating certain loan types,
2. First loss, best loss sale transactions (or no pain, no gain transactions) of the loans that have the greatest potential to be a drag on earnings, and
3. Adding ARMs to the portfolio in order to re-balance the risk profile.

WHAT DO MORTGAGE LOANS HAVE TO DO WITH LIQUIDITY?

While NCUA Letter No: 22-CU-05 seems to place its emphasis on the addition of Sensitivity to Market Risk ("S"), the new release also redefines the Liquidity component and credit unions will want to understand what changes are made here as well.

Our focus in this article will continue with the mortgage portfolio and (while often overlooked as a source of liquidity) how it can play an important role in providing a large reservoir of potential liquidity, but only if you understand what makes mortgage loans liquid and price-efficient (i.e. converted to cash without an undue loss). Before we dive into evaluating mortgage loan liquidity, it's important to understand what the regulators will be focusing on as they evaluate liquidity.

For the re-defined Liquidity component, the ratings would be based on, but not limited to, the following:

- The adequacy of liquidity sources compared to present and future needs and the ability of the credit union to meet liquidity needs without adversely affecting operations or conditions;
- The availability of assets readily convertible to cash without undue loss;
- Access to sources of funding;
- The level of diversification of funding sources, both on and off balance sheet;
- The degree of reliance on short-term, volatile sources of funds to fund longer term assets;
- The trend and stability of deposits; and
- The capability of management to properly identify, measure, monitor and control the credit union's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

NOT ALL MORTGAGE LOANS ARE EQUAL WHEN IT COMES TO LIQUIDITY

Balance sheet management strategies can be structured to sell mortgage loans to reduce concentrations, interest rate risk exposure, or to provide liquidity for an institution's strategic growth goals such as an acquisition. The secondary market has standard criteria for what makes a mortgage loan liquid.

Chart 5 (next page) provides an example of a Liquidity Waterfall Filter Analysis that segments loans into one of three different categories — Portfolio, Private or Agency grade.

Not all mortgage loans are created equally in terms of liquidity and how you underwrite and document loans can have a significant impact the liquidity profile and price-efficiency of your loans.

Portfolio Grade – Portfolio Grade loans have characteristics that make them more beneficial to hold in portfolio as opposed to selling them in the secondary market. The market price of the loans typically does not align with the economic value of holding them in portfolio to term.

Private Grade – Private Grade loans have the credit profile, documentation and other characteristics that make them suitable to be sold to another credit union or institution in a private secondary transaction. These loans are highly liquid and price-efficient.

Agency Grade – Agency Grade loans are the top of the food chain in terms of liquidity and price efficiency. They are eligible for a seasoned bulk sale or securitization to Fannie Mae or Freddie Mac.

As you evaluate your liquidity sources, policies and procedures in light of Letter 22-CU-05, it's important to have an understanding of how liquid your mortgage portfolio is and how to document its potential liquidity for your Liquidity Contingency Planning document, which regulators are sure to be focusing on more intently in light of the new release.

As you may already have recognized, the liquidity profile of your mortgage loans takes on a new meaning when the market causes your strategic plans to go awry. This is because, when issues such as interest rate risk, concentrations, or liquidity shortfalls arise, the mortgage portfolio can be a significant tool in helping you reduce your risk or provide liquidity for strategic initiatives. Think of it as the fat deposits stored in the CAMEL's hump for survival in the desert (when authentic liquidity dries up)!

PROACTIVE NOT REACTIVE

Having been an ex-auditor of financial institutions for many years, I understand how being proactive can go a long way towards making your next exam go smoothly. Being proactive can take on a whole new meaning when the market takes a detour. When the regulators come in for your next examination in light of the new release, you'll want to understand how the post-pandemic artificially low-rate period has impacted your mortgage portfolio and its liquidity profile.

In some cases, you may need to demonstrate what you've already done to reduce your institution's exposure to interest rate risk (or Sensitivity to Market Risk), any strains on Liquidity (and being prepared to show how the mortgage portfolio can help), and perhaps most importantly how these areas will not have a negative effect on a third CAMELS component — Earnings. If there are problems in all these areas, the result could be a lower CAMELS rating. Because of restrictions on institutions with lower CAMELS ratings, a credit union would be prevented from growing its member base or keeping up with strategies to continue to serve its existing member base. When it comes to CAMELS, you'll want to make sure the fat deposits stored in these humps (i.e. ability to weather IRR, Liquidity and other issues) are ready for any severe changes in the market and regulatory landscape.

CHART 5: WATERFALL LIQUIDITY FILTER REPORT EXAMPLE

EXAMPLE INSTITUTION
ANYWHERE, USA
WATERFALL LIQUIDITY FILTER REPORT

1	2	3	4	17
Line Item	Description	No. Of Loans	Principal Balance	% Of Total
1	C : Portfolio Grade			
2	Currently Delinquent 30 or More Days	168	12,680,936	1%
3	Hist. DQ 30 or More Days Last 12 Mos	360	25,220,265	2%
4	Hist. DQ 30 or More Days Life of Loan (2)	0	0	0%
5	Borrower Credit Score Under 660	200	17,449,252	2%
6	Co-Borrower Credit Score Under 660	40	3,224,912	0%
7	Loss Mitigation \ Lender Modifications	0	0	0%
8	Loss Mitigation \ HAMP Modifications	0	0	0%
9	Loss Mitigation \ HARP Modifications	0	0	0%
10	Mobile Home \ Manufactured Housing Collateral	0	0	0%
11	Housing Co-Operative Share Loan	0	0	0%
12	DTI Ratio Over 50 %	176	16,135,422	2%
13	DTI Ratio > 45 % Seasoned < 36 Mos	116	8,566,913	1%
14	No Documentation of Income\Assets	0	0	0%
15	Original Balance Under $15,000	244	1,156,800	0%
16	Current Balance Under $15,000	596	4,947,298	0%
17	Updated LTV Over 104 % & FHA\VA	0	0	0%
18	Updated LTV Over 95 % & O\O With PMI	0	0	0%
19	Updated LTV Over 80 % & O\O Without PMI	72	9,409,577	1%
20	Amortized LTV Over 104 % & FHA\VA	0	0	0%
21	Amortized LTV Over 95 % & O\O With PMI	28	4,022,511	0%
22	Amortized LTV Over 80 % & O\O Without PMI	0	0	0%
23	Adjustable Rate & Margin Over 4 %	0	0	0%
24	Non-Private Investor Eligible	0	0	0%
25	**Subtotal**	**2,000**	**102,813,886**	**10%**
26	B : Private Grade			
27	Original Balance Over $1,500,000	0	0	0%
28	Current Balance Over $1,500,000	0	0	0%
29	Original Balance Over Agency Maximum	100	75,800,693	7%
30	Current Balance Over Agency Maximum	0	0	0%
31	Updated LTV Over 90 % & O\O With PMI	0	0	0%
32	Updated LTV Over 75 % & Second or NOO	180	31,668,501	3%
33	Updated LTV Over 75 % & Cash Out Refi	328	28,920,975	3%
34	Updated LTV Over 70 % & Condo	0	0	0%
35	Amortized LTV Over 75 % & Second or NOO	352	62,286,125	6%
36	Amortized LTV Over 75 % & Cash Out Refi	164	18,162,837	2%
37	Amortized LTV Over 70 % & Condo	0	0	0%
38	Investor Property & Condo Collateral	0	0	0%
39	Limited Documentation of Income\Assets	0	0	0%
40	Simple Interest Payments	0	0	0%
41	Interest Only Payments	32	2,221,044	0%
42	LIBOR Indexed ARM Seasoned Over 6 Mos	0	0	0%
43	Adjustable Rate & Margin Over 3.5 %	100	2,828,234	0%
44	Adjustable Rate & Periodic Cap Over 3 %	0	0	0%
45	Non-Agency Investor Eligible	76	8,082,489	1%
46	**Subtotal**	**1,332**	**229,970,899**	**23%**
47	A : Agency Grade			
48	No Data Exceptions Coded	7,612	684,026,855	67%
49	**Subtotal**	**7,612**	**684,026,855**	**67%**
50	**Grand Total**	**10,944**	**1,016,811,640**	**100%**

Investment Grade

Source: FHN Financial Capital Assets Corp

Link to NCUA Letter to Credit Unions CAMELS Rating System | National Credit Union Administration (ncua.gov)

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