

In April 2022, we explained why the NCUA’s NEV Supervisory Test began to produce less favorable results for many credit unions. These results are primarily related to higher interest rates and a shift in the yield curve. We’d like to take this opportunity to update you regarding test results and explain the trends that we have seen.

NCUA NEV Supervisory Test

The NCUA’s NEV Supervisory Test is a balance sheet risk measure which calculates net economic value in the current interest rate environment and up 300 basis point scenario. The test incorporates asset values and term liability values from McQueen’s ALM model. Thereafter, the test applies standardized NCUA-defined non-maturity deposit premiums of 1% in the base scenario and 4% in the up 300 basis point scenario. This method does not capture the true value of non-maturity deposits and therefore will result in less favorable and sometimes more volatile results. The NCUA’s NEV Supervisory Test is part of the exam process, designed to assess the credit union's interest rate risk and define the exam scope. Examiners consider two tests with results classified as low, moderate, high, or extreme. The exam scope may be scaled up or down depending on the risk level identified. For purposes of this example, let’s assume that the post-shock NEV ratio is 6.5% and that NEV sensitivity in the up 300 basis point scenario is -50%.

- Part 1 (Top Scale): NEV sensitivity results from -40% to -65% indicate a Moderate level of risk.
- Part 1 (Left Scale): A post-shock NEV Ratio between 4% and 7% also indicates a Moderate level of risk.

“Exam scope may be scaled up or down”

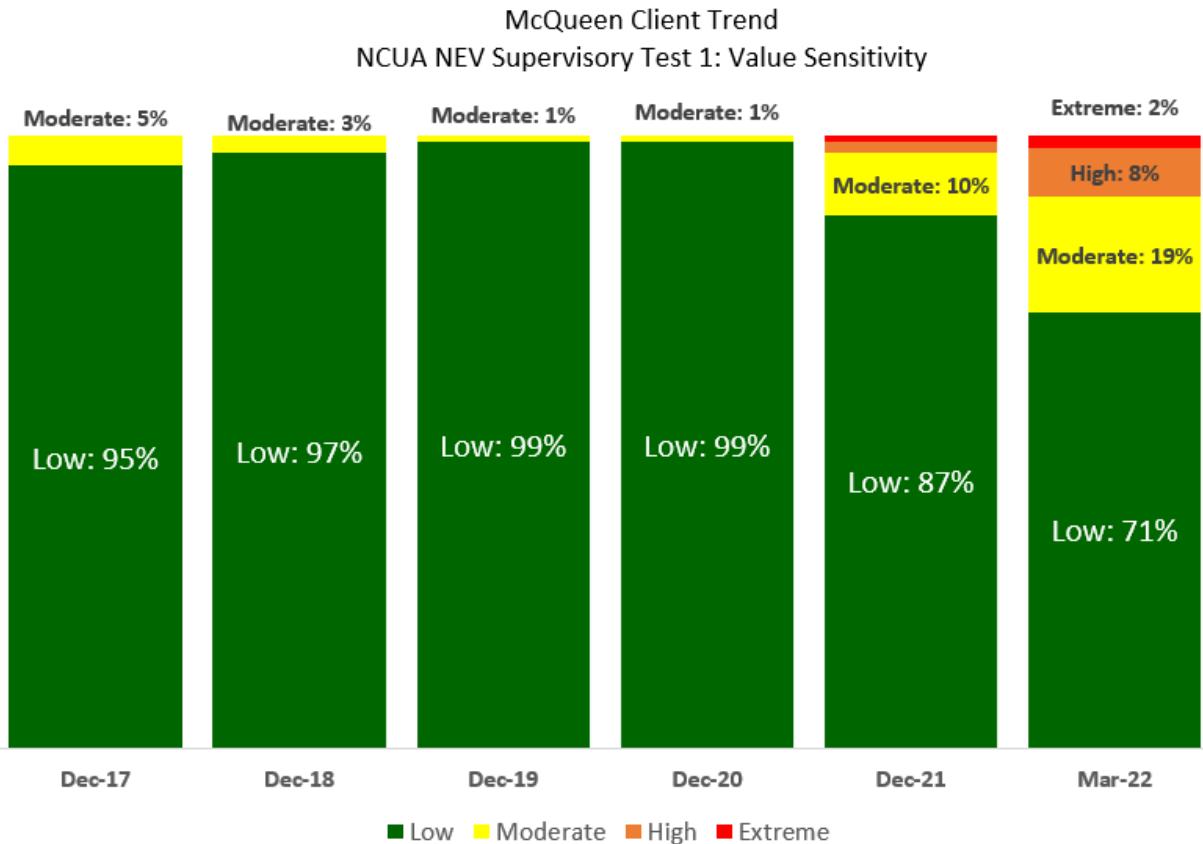
Post-Shock NEV Ratio	NEVE Value Sensitivity (% change from Base)			
	Below 40%	40%-65%	65%-85%	Above 85%
Above 7%	LOW Low-Supervision Details Routine examination and supervision process			
Between 4% and 7%	MODERATE Moderate-Supervision Details Routine examination and supervision process			
Between 2% and 4%	HIGH High-Supervision details, higher management expectations. Possible heightened supervision. May need to de-risk.			
Below 2%	EXTREME Unsafe and Unsound. Close Supervision Required. Must de-risk (reasonable time). May necessitate PCA reclassification.			

Trends

Many of our clients were surprised to see less favorable NCUA NEV Supervisory test results starting in late 2021. Since the test was introduced in 2017, between 95% and 99% of our clients were identified as having a low level of risk on both tests. It was also exceedingly rare to have any clients in the high or extreme categories on either test. Many credit unions with very stable balance sheets have never seen test results other than low. What happened? We first started seeing less favorable test results in 2021, after intermediate interest rates began to rise. In response, we carefully reviewed model inputs, assumptions, yield curve shifts, and balance sheet changes for every client. Changes to the slope and shape of the yield curve were identified as the reason for less favorable test results. Interest rates continued higher, and we saw a modest shift out of the low-risk category to less favorable categories of moderate, high, and extreme.

As of March 2022, the results of test 1 show that 71% of our clients are in the low-risk category, 18% Moderate, 8% High, and 2% Extreme.

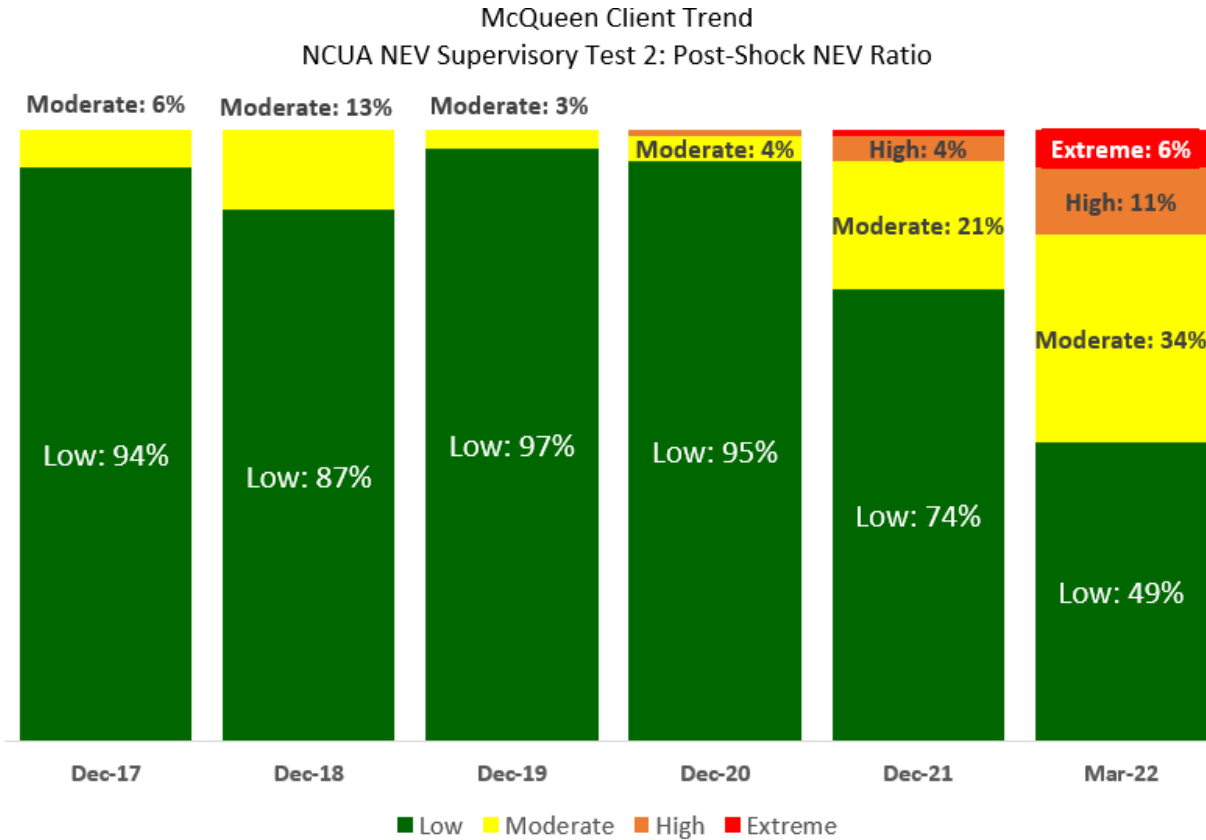
“Changes in the slope & shape of the yield curve”



Trends (continued)

As of March 2022, the results of test 2 show that 49% of our clients are in the low-risk category, 34% Moderate, 11% High, and 6% Extreme.

“Heightened level of risk”



Commentary

In our daily consulting work, clients across the country share with us their exam experiences. Some of them use McQueen’s ALM model and others do not. Well before these tests started to indicate a heightened level of risk, our consulting team advised clients about the risk of holding long-term assets, excess mortgage loans, and callable bonds. Our team of seasoned veterans understands that a prudent approach is necessary when interest rates are very low. It’s not surprising that NEV test results for McQueen’s ALM clients have held up well compared to clients using other advisors.

Action Items

As a reminder, the NEV supervisory test is a rudimentary model used by NCUA and state examiners. While it seems counterintuitive, a balance sheet that hasn't changed much may still show less favorable test results over time. It's important to keep in mind that the test is used to set the scope of your exam. In our recent experience, it appears that most examiners understand the limitations of the NCUA's test and take a reasonable approach when viewing these results.

We encourage you to review your risk profile in relation to policy limits and the NCUA's NEV Supervisory Test results carefully.

We have the following recommendations:

- Understand that NEVE results are based on a simultaneous, across-the-board shock test. All interest rates are assumed to increase immediately. Interest rates do not typically move up quickly by 300 basis points or more.
- Review this document and NEV sensitivity results carefully.
- Include a discussion of NEV sensitivity and the trend in ALM meeting minutes.
- Understand that the NCUA's NEV Supervisory Test assigns low value to non-maturity deposits.
- Discuss internally the reason for less favorable results over time, which is primarily related to higher rates and a shift in the yield curve.
- Consider that less favorable results on the NCUA's test may cause examiners to widen the focus of your next exam.
- More favorable NEV sensitivity can be achieved by growing short-term or floating-rate assets or by growing longer-term liabilities. This is not a broad recommendation, because shorter-term assets generally provide lower yields and longer-term liabilities may add to interest expense. Talk to us about your specific results.
- Talk to your McQueen advisor, who will interpret the results and may be able to discuss risk mitigation strategies.
- Learn about and use McQueen's new 24/7 On Demand ALM Simulation tool which can measure the impact of balance sheet changes with a few clicks or call us and we can do the modeling with you.

***“Talk to us
about your
specific
results”***