



**Mark H. Smith**  
I N C O R P O R A T E D

# ESSENTIALS FOR AN EFFECTIVE ALCO

Presented by:  
Cynthia R. Walker, CEO

*(Webinar will begin on the hour)*

For CPE credit you must participate  
in all the questions



# Topics

- **Organizing the Asset Liability Management Committee (ALCO)**
- **Define the ALCO Function**
- **Explore information and reports needed**
- **Ways to increase ALCO effectiveness**

# ORGANIZE

Committee (or individuals)  
designated by the Board

Bring key decision-makers together

- **CEO**
- **CFO**
- **Lending**
- **Marketing**
- **Board of Director representative**
- **Others as needed**



# OVERSIGHT



Credit unions are required to have policy and process in place

identify  
measure  
monitor  
manage  
control interest rate risk.



Board of Directors are responsible for the policies



Policies defines limits/appetite for risk.



Board can delegate the process

# OVERSIGHT

INCLUDES

**Loans**

**Investments**

**Funding/deposits**

**Liquidity**

**Concentrations**

# STRONG DECISION MAKERS

- Understand CU's exposure to changing interest rates
  - Anticipate and mitigate earnings fluctuations
  - Know the impact on the economic value of the balance sheet
- Anticipate pressures on loan and deposit rates
  - Real vs Phantom
  - Deposit balance changes and needs
- Monitor liquidity positions
  - What we have now
  - What do we need? Today, this month, this quarter.....
- Other considerations
  - Credit/delinquency

# STRATEGIC

Identify exposures

Develop responses to  
exposures

Oversee  
implementation  
of plans

Track risk to policy  
limits



# Poll Question #1

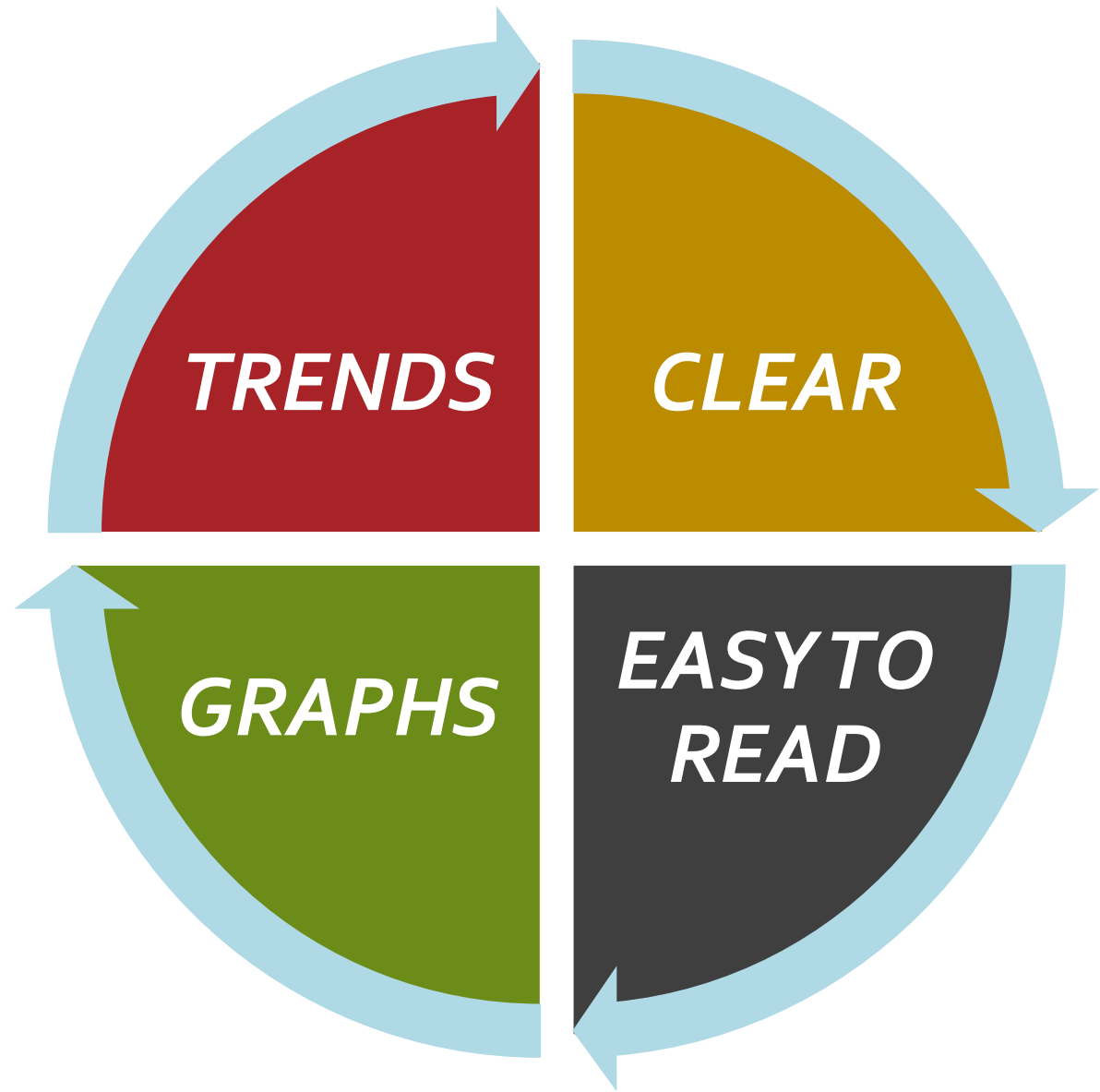
REPORTS

INFORM  
AND  
PROMOTE  
DISCUSSION

## Key ratios and statistics

- Average loan yields
- Average cost of funds
- Net interest margin
- ROA
- Loans to total assets
- Growth
- Net worth ratio

# REPORTS



# FUNDING DISCUSSION (Deposits)

## CORE DEPOSITS

Define and understand

## RATE SENSITIVITIES

Understand how earnings will be impacted as interest rates change

## STRATEGIES

How to control or manage cost of funds

## CASH FLOW

Anticipate loans and deposits inflow and outflow  
Likely scenario and stress events

# MONITOR LIQUIDITY POSITION

- Static liquidity ratios
- Economic conditions that may impact liquidity
- Develop options and responses
- Compare results to policy
- Recommend corrective action when necessary



# COMPETITIVE POSITION

- Rates charged and paid in the marketplace
- CU rates ensure profitability
- Do the CU goals match the ability
- Evaluate credit union philosophy
- Loan rates and deposit rates are equitable to both borrower and saver

# Poll Question #2

# ALCO MUST UNDERSTAND



Can be manipulated to provide desired outcome



IRR results relied on by ALCO and Board



Balance sheets complexity and leverage



Some CUs are taking on new risks



Will be reviewed by regulators

# IMPORTANCE OF MODEL ASSUMPTIONS



# LOANS – FOCUS ON LARGER BALANCE ACCOUNTS FIRST

## IMPORTANCE OF MODEL ASSUMPTIONS

### Classifications

Type

Terms

Rates

### Prepayments

Cash flow

Different than  
loan terms

### Extension/ Refinance risk

As interest rates  
change, payment  
behaviors change

# INVESTMENTS – FOCUS LARGER BALANCE ACCOUNTS FIRST

## IMPORTANCE OF MODEL ASSUMPTIONS

### Classification

- Types
- terms

### Options— Calls/steps

Complex mortgage-  
backed securities  
Cash flows change as  
interest rates change

# REGULAR SHARES AND SHARE DRAFTS HAVE LARGE IMPACT

## IMPORTANCE OF MODEL ASSUMPTIONS

### Betas

- Rate sensitivity

### Lags

- Time to raise rates

### Decays

- How long deposits stay

# MODEL ASSUMPTIONS

## Key elements to managing the assumptions

- Assumptions are supportable and documented.
- Discuss in ALCO and document in minutes
- Review assumptions annually by ALCO and document
- Consider external data comparisons
- Take a fresh look at assumptions



# CONSEQUENCES OF ASSUMPTION ERRORS

## Underestimating risk

- Decline in earnings
- Negative earnings
- Decline in capital
- Missed opportunities in the future

## Overestimating risk

- Lost income
- Lost opportunities

# INTEREST RATE RISK ANALYSIS

Net Interest Income (NII) and  
Net Income (NI) at risk

Net Economic Value (NEV)

Summary Report

Trends

# CONSIDER ALTERNATIVE SCENARIOS

## But don't overwhelm

- Increased rate sensitivities
- Shorter decay
- Alternative rate shock scenarios
- Change deposit composition - less sensitive to more rate sensitive
- NCUA supervisory test

INTEREST RATE RISK  
ANALYSIS  
OTHER USES

- Model new business
- Compare results to policy
- Recommend corrective action when necessary



# CONFIDENCE IN RESULTS

- Back-testing NII simulation
- Account for variances and document results
  - Rate/Volume
- Sensitivity analysis
- Validation/third-party review





## GOOD ASSUMPTIONS WHEN ESTIMATING INTEREST RATE RISK

**Perfect assumptions do not exist**

**Most important—share and loan behavior**

**Consequence of material errors—serious**

**Back-testing—improves process**

**Sensitivity analysis helpful**

**Understand which assumptions have the most impact**

# Poll Question #3

# ENSURE THE BOARD IS INFORMED

## ALCO REPORTS TO THE BOARD

- **Defined reporting procedures**
- **Define who is responsible for reporting to the board**
- **Establish frequency**
- **High-level reports with comparison to policy limits**
- **Income simulation current results and trends**
- **NEV current results and trends**
- **Liquidity historical and forecasted**

# FINAL THOUGHTS



Periodically evaluate policy limits for reasonableness and make recommendations

Be prepared and be **EMPOWERED**

Credit union management objectives may not **ALWAYS** coincide with regulatory objectives

# SUMMARY

**ALCO is the place to pull it all together**

**ALCO utilizes information to make decisions and aid in managing the credit union.**

**Strategize, plan, and prepare for multiple situations**

**Review new products, and balance sheet shifts for potential exposures.**

**Document, document, document the process.**

## MHSI EASY AND AFFORDABLE SOLUTIONS

CECL CALCULATION AND REPORTS

THIRD-PARTY REVIEW (NON-CLIENT)

MHSI OUTSOURCES SOLUTIONS

- Save time
- Delegate to the experts
- Have access to extensive experience
- Receive help with exams and responses
- Have a reliable resource
- From a friendly and reputable company





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