volcorp
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THE FRONTBURNER

Welcome to the April edition of *The FrontBurner*. Last month, we discussed what some credit unions are doing in response to over-inflated balance sheets in an environment where yield is hard to come by. The pitfalls of chasing yield the wrong way are very real, while the advantages of doing it the right way can be significant. We hope we provided some guidance in finding that equilibrium for you.

For this month's edition, we provide some complementary information. This time from the ALM view of things. As many credit unions continue to venture into new territory with their investments portfolios, it is key to understand the impact doing so will have on your modeling results and strategic decisions going forward. We can help you analyze that impact before you pull the trigger.

VolCorp, of course, is navigating through the same tough environment you are with an abundance of assets coupled with limited alternatives in which to invest them for meaningful return. We think through these same decisions every day and are proud to be able to share our expertise with you.

April is a big month for us as we celebrate 40 years of serving credit unions with our 40th anniversary on April 21st! We have some big things planned for this milestone year, and we have some fun things planned for the month of April to acknowledge the anniversary. While we may not be in an environment conducive to celebrating in person just yet, we hope you will celebrate with us from afar. We are honored to be just a small part of helping you succeed. Proud to serve you for 40 years...and counting.

Jeff Merry, President/CEO

volcorp 40 YEARS BOLDER XL 1981-2021

What-If Modeling:
Using ALM for Strategic Decisions

The National Credit Union Administration (NCUA) defines Asset Liability Management (ALM) as "the process of evaluating, monitoring, and controlling changes in the credit union's market and balance sheet risk. These risks can adversely affect earnings and capital adequacy."

NCUA requires a written interest rate management policy and ALM program for credit unions who meet the following criteria:

- Over $50 million in assets; or
- Under $50 million in assets who hold first mortgages and/or investments with maturities greater than 5 years which are equal to 100% of net worth at a quarter-end.

With every ALM program, there are important questions that should be asked. These include:

- Are you just using your ALM to satisfy regulatory requirements, or are you using your ALM model to assist in strategic decisions for your credit union?
- More specifically, how familiar are you with where your specific risk lies within the balance sheet and are you maximizing, or at least attempting to maximize, earnings in areas where your risk is the highest?
- Does your balance sheet reflect management of risk that matches your strategy and policy?

Regulations require credit unions to run an ALM model at a worst-case scenario. The worst-case scenario in today's environment is an instantaneous, parallel, up 300 basis point shock with a static balance sheet.

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(Remember the days when it was down 300 basis points as well?) By using this scenario, it allows your regulator to easily compare the results and the impact on net worth over time. Thus, your credit union has complied with regulatory guidance.

As the famous infomercials state, "*But wait there is more,*" or at least there could be more in regards to using ALM modeling strategically. Let me ask you, what are the chances your Asset Liability Committee will move all loans and shares, that can be repriced immediately, up by 3%? Also, what are the chances you will not adjust your balance sheet composition, growth strategies, non-interest income and expenses to compensate? I would say the chances are very slim.

The "what-if" allows the credit union to define ALM assumptions as to what really could happen within your four walls.

This is where the "what-if" model, also commonly referred to as a dynamic simulation, comes into play. The "what-if" allows the credit union to define ALM assumptions as to what really could happen within your four walls. For instance, historically credit unions have not moved market-to-market on non-maturity share and certificate rates. Maybe your credit union typically moves only 25% of the market indicator you use. Also, maybe you do not move right away because your membership is just not that rate sensitive, so maybe you move your non-maturity shares rates within six months and your certificate rates within three months. In this current environment, is it fair to assume that you would not mind some of those shares going out the door? If so, it is also safe to assume your movement on member share rates would move less and at a slower pace than the market movements. This would definitely have an impact on your overall net interest margin. Let's put that into the model.

Now for the other side of the balance sheet. Unfortunately, we are living in a world of low loan demand, except those mortgage refi's, which I will get to in a minute, and investments with a low yield. What would happen if you booked fixed-rate 30-year mortgages at 3.25% and bought the long-term fixed-rate bullet investment? How are you funding these loans and investments? Will the addition of these assets change your balance sheet composition or your overall growth strategy? You have to be careful not to have a disproportionate amount of fixed and variable rate instruments on either side of the balance sheet. Why? Well, one day rates will rise again. Let the "what-If" model help you make these decisions.

With mortgage rates low and home buying still occurring, credit unions are seeing mortgages on their books pay off and being replaced at lower rates. In years past, credit unions understood that a percentage of their mortgage loans would not see maturity due to members selling their current home or refinancing to a lower rate or shorter-term. With the rates already low and uncertainty on the full impact of the pandemic on member behavior, there could be a good chance these loans stay on the books longer than expected. While I am not suggesting you stay away from fixed-rate mortgages within your loan portfolio, just to understand the concentration limit for these types of loans your balance sheet can handle without increasing your overall interest rate risk. Again, a what-if model can help in this strategic decision.

A word of caution: it may take a few attempts to get your "what-if" model to truly analyze where risk could lie. Also, don't forget to document, document, and document your assumptions within your normal model run and the what-if models. All assumptions need to be well supported as you discuss strategic decisions with your examiner and your Board of Directors. I once had an attorney tell me, "The person with the most documentation wins." I think this could apply for ALM as well.

At the end of the day, use your worst-case scenario and your what-ifs as a best practice. Watch out for the red flags of increasing risk, large variances in model results that cannot be supported by back-testing, pressure on net worth, and declining net interest margin. Let the reports tell the story where you can take on more risk and where it should be avoided. Good luck!

For VolCorp ALM clients, if you would like to discuss this approach to ALM, please reach out to your ALM Analyst at ***alm@volcorp.org***.

If you are not an ALM client but would like more information on this service, please contact me at ***cadkison@volcorp.org***.