DCU BULLETIN

Division of Credit Unions

Washington State Department of Financial Institutions

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ALM Exam Procedures and Seminar on Interest-Rate Risk

The Division of Credit Unions (Division) recently revised its examination procedures used to evaluate how effectively a credit union is managing its interest rate risk (IRR). This examination revision was in response to the increasing level of IRR exposure found in some state credit unions based on 5300 data and on projected rising rates in coming months. The Division's enhanced procedures will recognize the differences in complexity of state credit unions as well as address a variety of areas for exam focus.

We Recognize Differences in Complexity

Our first concern in developing the new procedures was to customize the exam process in a manner appropriate to the complexity of the credit union operation and it's IRR. Our exam process will now define the scope of the IRR exam review as falling into one of the following IRR categories: "simple" "moderate," or "complex." Credit unions with conservative, short-term loans, deposits, and investments will only need to demonstrate a basic understanding of IRR. By re-pricing their shares and loans, those credit unions generally hold lower IRR. Larger credit unions or those with more complicated balance sheets will be expected to demonstrate a more comprehensive IRR management process. For credit unions with moderate to high IRR, the time and depth in examining its ALM program will be dependent on a variety of factors including asset size, net long-term assets, real estate loans, 17-4 shocked net worth reduction, type and complexity of securities held in the investment portfolio, loan and share growth, and borrowed funds. With such a variety and possible combinations of factors it would be difficult to be more specific about the line between "moderate" and "complex" in this short document.

We Will Increase Our Focus in a Variety of Areas

In developing the updated exam procedures, the Division recognizes that focus on certain practices may be very effective in reducing and/or managing risk. Except for credit unions with "simple" IRR, our examiners will focus on the following areas of analysis:

<u>Model Sophistication</u>

Examiners have found some credit unions using simple (for example GAP) or no ALM models for their more complex balance sheets. The result can be inadequate measurements of IRR. A credit union with significant IRR must determine which particular ALM model to use in identifying, measuring, and monitoring interest-rate risk. The model must be sophisticated enough to provide results that give management appropriate information to effectively manage its IRR. The Division will focus attention on those credit unions with inadequate measurement systems that could lead to inappropriate decisions.

Importance of Assumptions and What-if Scenarios

Examiners are finding problems with assumptions and "what-if" scenarios. One problem is with models using default assumptions instead of assumptions tailored to the credit union's balance sheet. The assumptions used in the model must represent realistically anticipated behaviors, particular practices, and pricing strategies for that credit union. A good example would be to assume non-maturity shares (such as regular shares and drafts) are all core deposits and not rate sensitive, when in fact the credit union has been paying above market rates. Faulty assumptions could unreasonably decrease the reported IRR and lead to poor decision-making.

Integration of ALM with Strategic Planning

We are finding some ALM programs are lacking integration with long-term strategic planning. Many activities or products identified during strategic planning could have a direct impact on the structure of the balance sheet, and thus your IRR profile. Effective model results require the use of assumptions that are consistent with strategic plans and the credit union's commitment to implement them. Without that "commitment," model results will not be useful. A good example is a strategic plan to sell fixed rate, long-term mortgage loans, which should help control IRR. However, if management is only willing to sell loans when a profit can be realized, the impact of IRR may be significantly increased when management procrastinates selling loans at a loss during a rising rate environment.

Policy Limits and Adherence to Policy

Examiners have found a few instances where the credit union increased the risk limits rather than implementing sound IRR mitigation plans. As part of the enhanced exam procedures, Division examiners will pay close attention to those risk limits (or parameters) set by the Board in policy. Lack of limits or unrealistic limits will be criticized since it is the Board's responsibility to define those limits in directing the credit union's tolerance for risk. We will also determine if management is adhering to those limits and what plan of action the Board has defined for those occasions when the limits are exceeded.

Measurement System Validation

Examiners have found some credit unions believe that the examination process is sufficient to validate the credit union's model. This is not true. We emphasize that the Division does not validate your model through our examination. It is very important for the credit union to have its model independently validated on a periodic basis. This requires a reconciliation of actual operating results and market values with those projected in a prior period IRR analysis. Flaws in processing, assumptions, or model results can be identified through this activity and can lead to more accurate risk estimates in the future. The credit union is responsible for developing your own validation system.

ALCO Activities and Reporting

In some instances, examiners have found that the ALCO has not been performing all of the functions necessary or has not been reporting to the board of directors adequate information for the directors to fulfill their role. Your Asset-liability Management Committee (ALCO) will be reviewed for effective contribution to the management of the process. The ALCO's reports to the Board should provide enough information for effective monitoring of credit union risks by the Board. Our analysis on the composition of your ALCO will flow from the previously addressed scoping of your credit union's complexity.

Summary

Several factors are now combining to bring attention to the need for sound IRR management practices. First, an increased number of credit unions now have significant levels of long term fixed rate assets. Second, interest rates have begun to rise. Third, our examiners have identified a number of ways the IRR management could be improved. Credit union regulators across the country are expressing similar concerns. The Division will be working in a variety of ways to share our understanding of sound interest rate risk management practices.

Seminar on Preparing for Rising Interest Rates

On September 30, 2004, the Division and the Washington Credit Union League will be hosting a free seminar on Preparing for Rising Interest Rates through Strategic Planning. This seminar will consist of a one hour web-cast presented by The Paragon Consulting Group, followed by a one and a half hour facilitated discussion. To facilitate the discussion, there will be a representative from the Division and a representative from a credit union with expertise in managing interest-rate risk. The topics of discussion will include your questions and may also include:

- ✓ Review of ALM principles
- ✓ Why interest rates are increasing
- ✓ Looking at your assets and liabilities
- ✓ How to use the Paragon Income Model (free spreadsheet with registration)
- ✓ Considerations before changing interest rates
- ✓ Tracking effects on your credit union
- ✓ Prioritizing your actions
- ✓ Areas of focus for Division exams
- ✓ Sources for additional support

We have chosen five locations throughout the state to make attendance as convenient as possible. The locations include Everett, Federal Way, Spokane, Vancouver, and Yakima. We encourage attendance from the Board and senior operating staff.

For more information on the seminar and for registration you may go to the WCUL website at www.waleague.org/edreg_risingrates.html. We ask that registration be complete by September 3. The Division believes the consultants from Paragon will provide valuable information for credit union directors and management but we do not endorse either the consultants or their IRR products. For additional information, please call Doug Lacy-Roberts at (360) 902-0507 or Jane Johnson at (360) 902-0508.