I. PURPOSE

Asset Liability Management policies, procedures and controls are reviewed to determine management's effectiveness in managing the balance sheet and to evaluate the adequacy of the credit union's liquidity. Procedures to measure interest rate risk, liquidity risk, concentration rick, strategic risk and reputation risk are also reviewed. Policies and procedures must be appropriate for individual credit union operations.

II. PRIMARY REFERENCES

1. Michigan Credit Union Act:
   a. Section 342: Credit union Board
   b. Section 401: Domestic credit union; powers
2. NCUA Rules and Regulations Part 741
3. NCUA Appendix A to Part 741; Guidance for IRR policy and effective program
4. NCUA Letter 10-CU-03 Concentration Risk
5. NCUA Letter 01-CU-08 Liability Management
6. FFIEC Interagency Guidance on Interest Rate Risk Management

III. MINUMUM PROCEDURES

1. Review the adequacy of the policies and procedures relative to ALM to ensure they are sufficient given the size and/or complexity of the credit union. ALM policies should:
   a. Establish procedures for identifying, measuring, monitoring, controlling, and reporting interest rate risk (IRR) and liquidity risk.
   b. Establish risk limits.
   c. Provide adequate detail for the appropriate parties (e.g., board, ALCO, management, investment officer) to understand the risk limits and their individual responsibilities.
   d. Document assumptions and rationale for assumptions.
   e. Complete multiple scenario testing for NEV (changes in balance sheet composition, strategic initiatives, mergers, branches, changes in economic conditions, varying interest rate scenarios) on a quarterly basis.
   f. Require model validation by an independent third party.
   g. Assumption testing/sensitivity testing performed every year or when there is a material change (borrowing to fund a new program, adding a branch (unplanned expenses, deposit growth, merger combination of

balance sheets) economic conditions (rising unemployment, falling yields, etc.))

2. Review the previous Report of Examination for ALM exceptions and/or weaknesses and determine if appropriate corrective action has been taken.

3. Determine whether the ALM process is adequate and commensurate with the institution's risk profile.

- **a.** Overall, successful ALM programs encompass the following practices:
  - **i.** Identifying goals and objectives;
  - **ii.** Developing strategies;
  - **iii.** Creating policies and procedures;
  - **iv.** Managing product offerings and pricing;
  - **v.** Identifying, measuring, monitoring, and controlling exposures to risk;
  - **vi.** Generating adequate income and net worth over varying economic conditions; and
  - **vii.** Maintaining financial flexibility.
- **b.** In small or basic service credit unions, the ALM process can be basic, consisting of the following:
  - **i.** Awareness of member share and loan needs;
  - **ii.** Relatively short-term loans and investments;
  - **iii.** Ability to adjust dividends and loan rates to changes in the market;
  - **iv.** Adequate earnings and net worth.
- **c.** In large or complex credit unions, the ALM process requires more sophisticated analysis, including income simulation, duration and GAP analysis reports.

4. Review applicable board or committee minutes and reports. For larger and/or complex credit unions, sound business practice often includes forming an Asset Liability Committee (ALCO), which provides management oversight and guidance for the ALM program. The ALCO should hold regular meetings as required by policy and maintain minutes which establish a formal record of ALCO meetings and attendance. For ALCO meetings, the minutes should evidence the ALCO:

- **a.** Reviews IRR and liquidity risk exposure and compares the results to the limits established by policy;
- **b.** Develops proactive actions when the credit union's risk profile approaches or exceeds established risk parameters;

- **c.** Evaluates the current risk measurement system to ensure it adequately evaluates IRR and liquidity risk exposures;
- **d.** Understands the key assumptions driving the results of the ALM model;
- **e.** Makes recommendations to the board to mitigate risk or improve the ALM program.

VII. RED FLAGS

Examiners should be aware of the following red flags and expand the examination scope, as appropriate:

1. **High level of long-term assets to total assets:** High concentrations of assets, with maturities exceeding three years, reduces the credit union's ability to react to changing interest rates and exposes it to increased interest-rate risk.

2. **High level of net long-term assets to total assets:** A low net long-term asset ratio does not automatically eliminate the concern about high concentrations of long-term assets. Variable-rate features can present potential ALM concerns. The examiner should determine that the indices, margins, re-pricing intervals caps, and floors all provide sufficient protection against interest rate exposure.

3. **Declining net interest margin:** This margin should be relatively stable and sufficient to cover operating expenses and improve/maintain net worth. A declining ratio indicates either yields are falling faster than the cost of funds, or the cost of funds is rising faster than yields. The examiner should determine whether the credit union has any options to improve the net margin.

4. **Low level of net worth:** A low level of net worth, or a level of net worth that is not keeping pace with asset growth, weakens the credit union's ability to absorb losses and react to changes.

5. **Rapid asset growth or above market dividends:** Asset growth that outpaces the ability to generate sufficient net income reduces the overall strength of the credit union's net worth. Above market rates tend to attract rate-sensitive shares. If these deposits are invested in longer-term assets, the mismatch of maturities increases interest rate risk.

6. **Mismatch of asset/liability maturities:** The examiner may benefit from analyzing the changes in the balance sheet structure since the last examination or over previous year(s). For example, a credit union that may not have a

significant long-term asset ratio may have increased its share base into more rate-sensitive deposits (certificates of deposit, money market funds, shares greater than 10,000, etc.) during the last year(s). If the deposits were converted to longer-term fixed-rate loans, the incremental additions to the balance sheet may increase interest rate risk.

7. **Borrowing money for normal operations:** Frequent borrowing to fund normal operations could indicate low liquidity or poor cash flow management. The credit union should analyze historical cash flows and prepare a cash flow budget to help guide future loan and dividend decisions. A declining liquid asset to share ratio may indicate emerging liquidity risk.

VIII. ATTACHMENTS

1. 10510-A: ALM Definitions