The Nuts and Bolts…

(of Asset/Liability Management)

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Agenda

- What is ALCO?
- Why should I care?
- What do I do?

What is ALCO?

BUY $

- Retail
- Corporations
- Brokers
- Banks / CU
- Govt.

RISKS

1.
2.
3.

?

SELL $

- Retail
- Corporations
- Govt.
- Banks / CU

What is ALCO?

BUY $ →

1. CREDIT
2. INTEREST RATE
3. LIQUIDITY

→ SELL $

RETURN = NII

The ALCO Process

	MAXIMUM RISK		MANAGED RISK		MINIMAL RISK
CAPITAL	Low	⟷	Managed	⟷	High
GROWTH	High	⟷	Managed	⟷	Low
CREDIT RISK	High	⟷	Managed	⟷	Low
LIQUIDITY	Low	⟷	Managed	⟷	High
INT. RATE RISK	High	⟷	Managed	⟷	Low
	MAXIMIZE INCOME		OPTIMIZE INCOME		MINIMIZE INCOME

The ALCO Process

	by ALCO?	IF Not Then…
CAPITAL	Probably	By another system (s)
GROWTH	Probably	Policy states not important
CREDIT RISK	Probably Not	Separate committee
LIQUIDITY	Probably	By another system (s)
INT. RATE RISK	Absolutely	
•Basis / Yield Curve	•Maybe	•Policy states not important*
•Timing (options)	•Yes	•Policy states not important*
•Value	•Probably	•Policy states not important*

Objjjectives of the ALCO

Optimize Net Interest Income

(the return to my members)

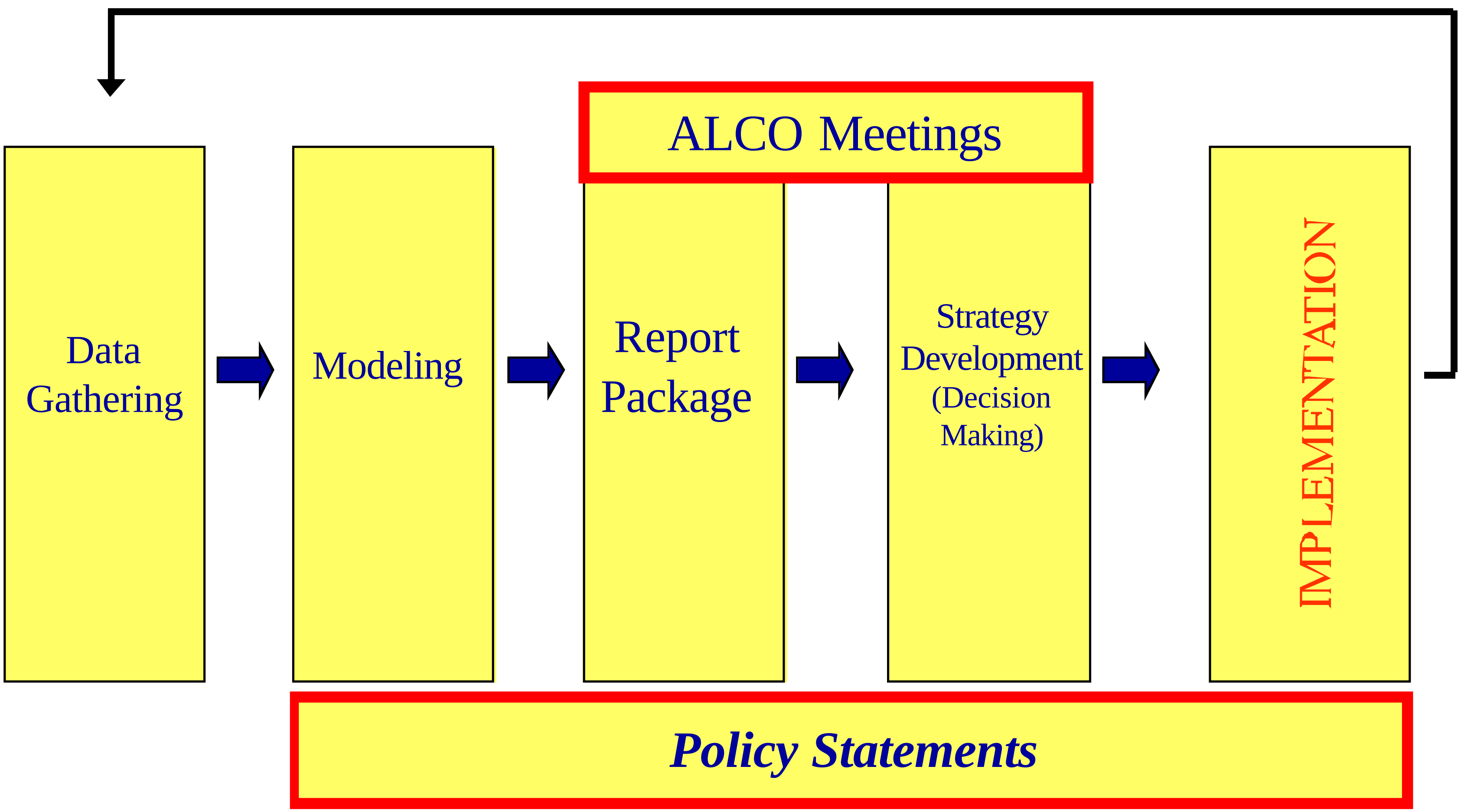
While Managing Levels of Risk

Primary emphasis on Strategy Development and decision making.

Impact/Influence:

Investment strategy
Loan pricing and product strategy
Share pricing and product strategy
Wholesale funding strategy
Capital management strategy

“Decision Oriented Process”



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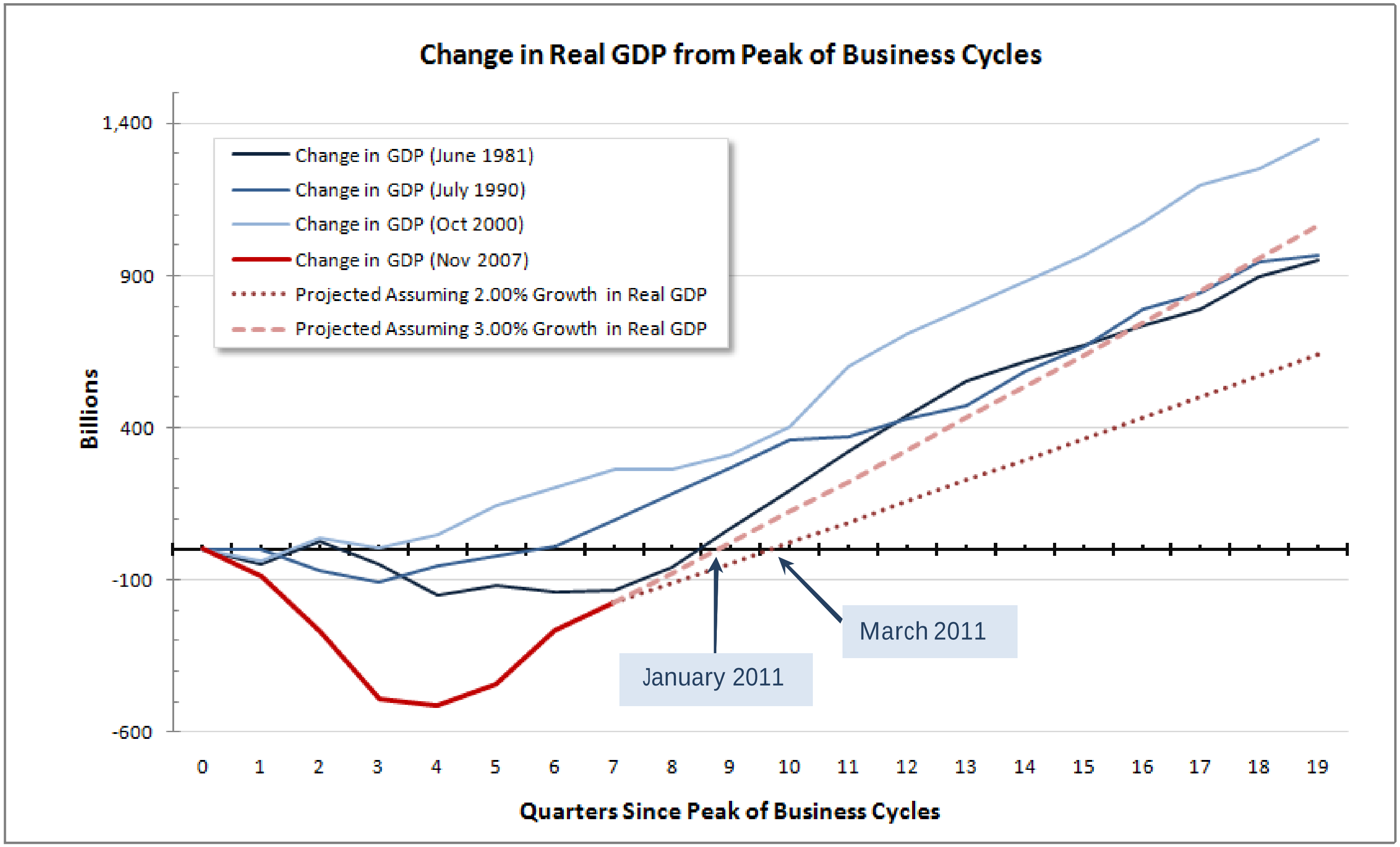
A Deep Recession and A Slow, Shallow Recovery

GDP	QoQ
June 2010	1.6
March 2010	3.7
December 2009	5.0
September 2009	1.6
June 2009	-0.7
March 2009	-4.9
December 2008	-6.8
September 2008	-4.0
June 2008	0.6
March 2009	-0.7
December 2007	2.9
September 2007	2.3
June 2007	3.2
March 2007	0.9



Beginning in November 2007, the Great Recession has seen GDP drop by 3X the loss of output we experienced in the early 80s.

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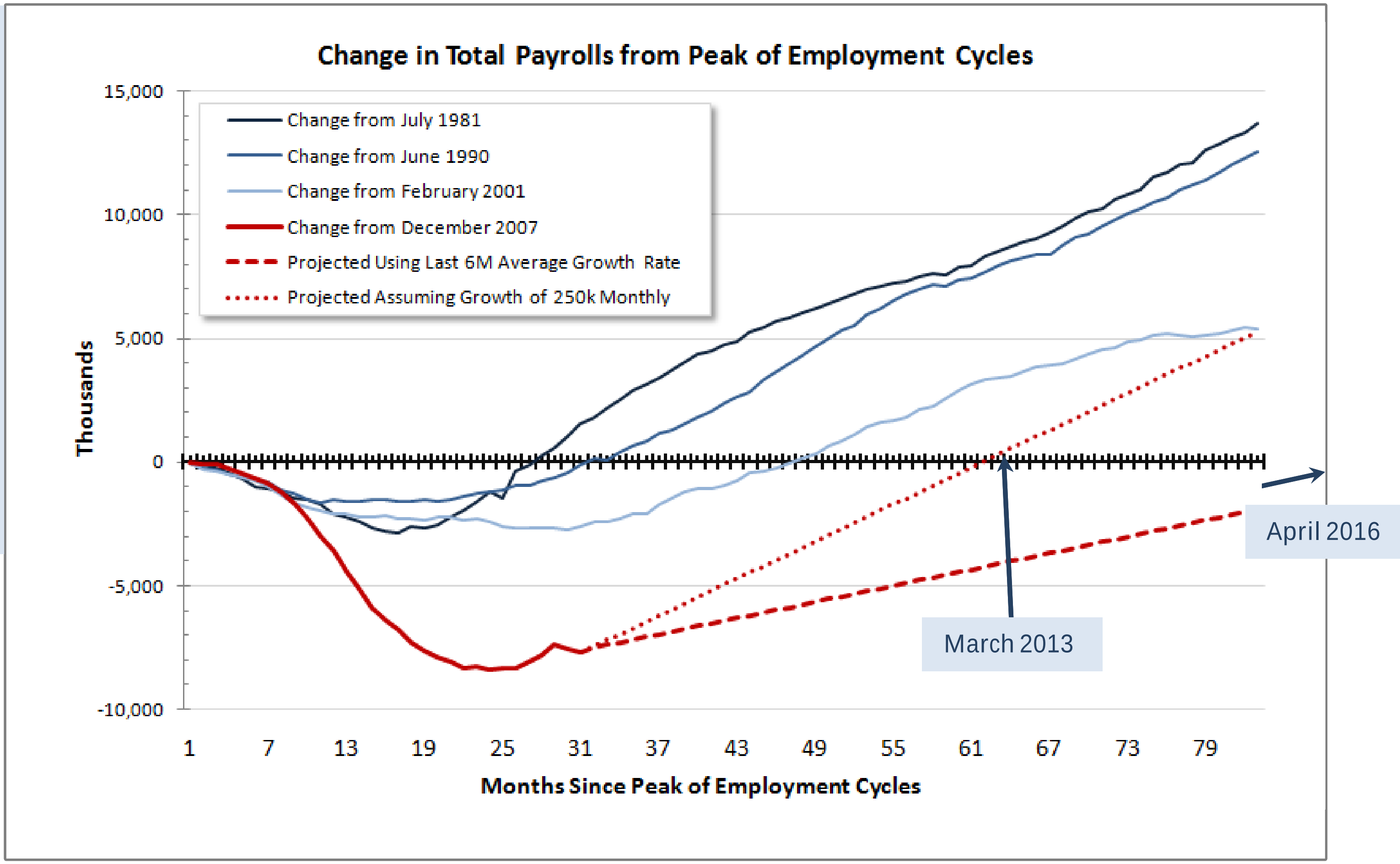
Sources: Bureau of Economic Analysis, **Vining Sparks**

Payrolls Tell the Same Story

Nonfarm Payrolls	Total	Private
August 2010	-54	67
July 2010	-131	71
June 2010	-221	31
May 2010	432	51
April 2010	313	241
March 2010	208	158
February 2010	39	62
January 2010	14	16
December 2009	-109	-83
November 2009	64	75
October 2009	-224	-262
September 2009	-225	-186
August 2009	-212	-215
July 2009	-346	-297

Monthly change in thousands



Similar to the loss in total output, the Great Recession has seen Nonfarm Payrolls drop by 3X the amount of lost payrolls we experienced in any of the recent recessions.

Sources: Bureau of Labor Statistics, **Vining Sparks**

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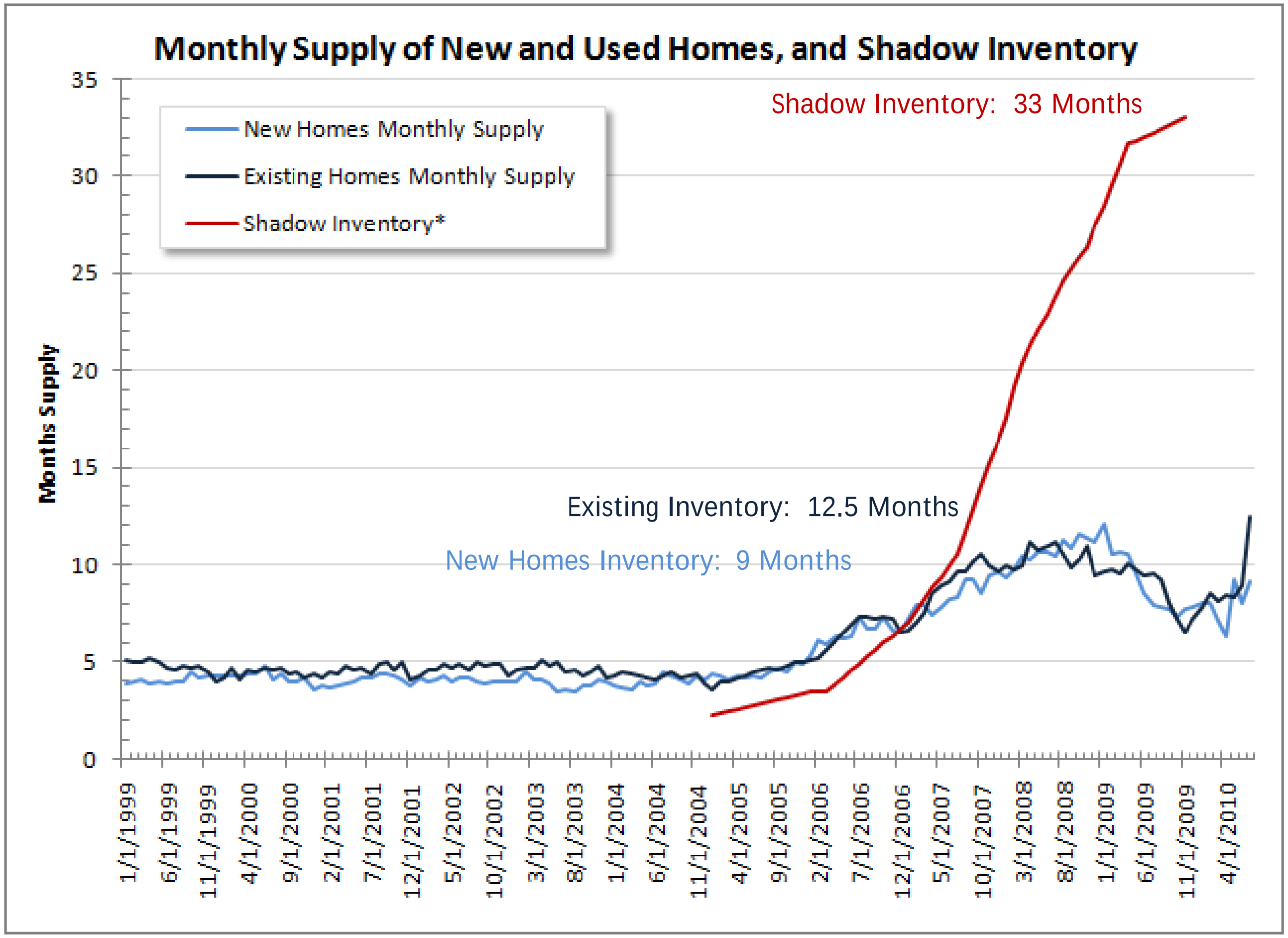
Shadow Inventory Will Keep the Pressure on Home Prices and Bank Balance Sheets

House Inventories	New	Existing
July 2010	9.1	12.5
June 2010	8	8.9
May 2010	9.2	8.3
April 2010	6.3	8.4
March 2010	7.1	8.1
February 2010	8	8.5
January 2010	8	7.8
December 2009	7.8	7.2
November 2009	7.7	6.5
October 2009	7.3	7.2
September 2009	7.7	8
August 2009	7.8	9.2
July 2009	7.9	9.5
June 2009	8.5	9.4

Inventory in months



* Months supply of shadow inventory derived from Standard & Poor's analysis of loans needing to be liquidated. It includes REO balances, Seriously delinquent balances, and assumed re-defaults of recently cured loans.

According to S&P, it will take 33 months to liquidate the $450B in non-performing loans making up the "shadow inventory." There will continue to be pressure on prices going forward.

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Sources: National Association of Realtors, US Commerce Bureau, Standard & Poors,

Current Environment

CREDIT UNION TIMES

HOME SECTIONS NEWS RESEARCH CAREERS BLOG ENEWSLETTERS

NCUA Seizes Three Corporate Credit Unions

9/24/2010

By Heather Anderson

NCUA today placed three corporate credit unions into conservatorship: the $7.4 billion Members United Corporate FCU, the $9.5 billion Southwest Corporate FCU and the $1.2 billion Constitution Corporate FCU.

At all three institutions, top management and volunteers were dismissed from their positions.

The three, along with U.S. Central FCU and Western Corporate FCU, own all of the securities that make up NCUA's $50 billion legacy assets plan. However, the three were not seized just to implement the plan.

Rather, Deputy Executive Director Larry Fazio said NCUA conducted a comprehensive analysis of the entire corporate system, with the assistance of the Federal Reserve, U.S. Treasury, and "lots of bonds experts." The analysis revealed the five corporates would not be able to recover from losses that depleted all or nearly all net worth.

Business will continue as usual in the three newly seized institutions, to enable them to continue to provide products and services to members who depend upon them, he said.

Recent Regulatory Guidance

FFIEC Joint Policy Statement – January 6th, 2010 – Advisory on Interest Rate Risk Management

- Key Points
  - Interest Rate Risk (IRR) is inherent in the business of banking
  - Directors are required to understand the magnitude and direction of IRR
  - The goal of the asset/liability committee (ALCO) is the measurement and management of risk, not the elimination of risk
  - IRR management should be commensurate with the size and complexity of the institution

STRATEGIC INSIGHT
PRODUCTS AND STRATEGIES FOR THE FIXED-INCOME INVESTOR

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SI 09-28 ■ July 20, 2009

Interagency Guidance on Funding and Liquidity Risk Management

On June 30, 2009 the OCC, FRB, FDIC, OTS and NCUA in conjunction with the Conference of State Bank Examiners issued a request for comments on a joint statement titled "Interagency Guidance on Funding and Liquidity Risk Management." This guidance is consistent with recent events affecting liquidity throughout financial institutions and an increased regulatory concern with liquidity postures. Although much of the guidance is a restatement of earlier publications, several comments are new, and could have a profound effect on balance sheet management. For a link to the proposed guidance, click here or visit: http://federalreserve.gov/newsevents/press/bcreg/20090630a.htm.

Definition

To begin, we must understand what the agencies mean by the term "liquidity." The definition given is, "Liquidity is a financial institution's capacity to meet its cash and collateral obligations at a reasonable cost." This definition recognizes that liquidity in its purest form is simply access to cash to meet obligations, and can come from both the asset side and liability side of the balance sheet. Liquidity Risk is defined as the "risk that an institution's financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its contractual obligations." These concise definitions, when combined with the remainder of the statement may change the way community financial institutions view liquidity and its management, and will potentially change management philosophy on balance sheet structure and corresponding strategic decisions.

Sound Practices

The proposed guidance includes a short section on sound practices of liquidity risk management. The structure of this section is consistent with guidance concerning other management activities, including a requirement for corporate governance and board oversight, policies and risk limits, and internal controls through the audit function. However, the section could also have far-reaching implications. First, sound practices define a process that measures cash available under various scenarios and the processes for determining that availability. There is no mention of traditional ratio-driven or asset-based liquidity measurement; in fact, the statement is void of traditional liquidity ratios. While this is consistent with recent policy statements by various agencies and embraces a proactive management stance, it will likely redefine the measurement process in many community institutions. Second, sound practice REQUIRES "Adequate levels of highly liquid marketable securities…that can be used to meet liquidity needs in stressful situations." This requirement is a recurring theme throughout the proposal, and changes the emphasis of balance sheet management away from an earnings focus concentrating on loan growth to a more balanced risk structure with an emphasis on safety and flexibility.

Corporate Governance and Policies

A result of this proposed guidance will be the transition of liquidity risk management from a secondary concern into a primary part of the management function. While the agencies recognize that liquidity risk management should be assessed in relation to the "size, complexity and scope of operations," clear guidance for the board of directors and senior management is emphasized. Key sections in the governance requirements include:

- Recognition of the "trade off" between liquidity and profits
- Increased board oversight of the liquidity process
- A requirement for a Contingency Funding Plan (CFP)
- Maintaining "liquid buffers of unencumbered marketable securities"
- Responsibility of the ALCO to manage the liquidity positions, including "broad representation across major institutional functions"

As mentioned above, a significant effect of the guidance may be the culmination of the industry move away from ratio-driven liquidity management to a sources-and-

continued ►

Regulatory Focus

- Regulators will focus on the process – we are already hearing this from those who have been recently examined

- Regulators will focus heavily on exposure to rising rates
  - If exposed to rising rates, be able to clearly detail your plan of action in the event rates do begin to rise quickly
  - Understand your exposure beyond year 2

- Be able to discuss the assumptions in your model
  - Determination of betas/ECRs
  - Modeling of loan floors

Regulatory Focus

Discussions with regulators will go much more smoothly if you demonstrate a sound understanding of your approach and your exposures and how you intend to respond if and when rates begin to change

- Best Practices
  - 2 year income simulation
  - Measure EAR in +/- 100, 200, 300 scenarios (up 400 recommended)
  - Measure NEV in the same scenarios
  - Monitor liquidity and capital ratios and how they change as rates move
  - Understand your exposures and have plans in place to react to changing interest rates if and when they do occur

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Board Responsibilities

- In the beginning, there were rules
- Then came…
  - Greater freedom
  - Greater responsibilities
  - Need to create an environment
- And ever increasing responsibilities for boards
  - Understand the issues
    - Risks
    - Ability to manage and take on risk
  - Build the fences within which management operates (Policy limits)
  - Set up the process
    - Reporting
    - Management

Board Role

- Board Responsibilities Include:
  - Approving Major Policies
  - Establishing Risk Limits
- Risk Management Process Includes:
  - Policies, Procedures, Risk Limits
  - Identification, Measurement, Reporting
  - Internal Controls
- Board Annual Reviews Include:
  - Investment Policies and Procedures
  - Risk Limits
- Other reviews and discussion:
  - Investment strategies
  - New endeavors

Board Responsibilities

The board should ensure .. “adequate resources are devoted to interest rate risk management”

“Management should ensure that the risk management process is commensurate with the size, scope, and complexity of the institution’s holdings”

(FFIEC Joint Policy Statement)

Questions to be Asked

- What types of risks need to be measured ?
- What level of complexity and risk are in the balance sheet ?
- What are the regulatory comments or concerns ?
- What are my staffing and cost capabilities?
- Do I understand the risks and opportunities of my balance sheet?

Underperforming ALCOs

- Will continue as is - a fear of change
- Will structure the reporting package and meeting around what think regulators want.
- Do not consider the ALCO important -
  - Usually lacks leadership and appropriate focus
  - "It's a finance thing" a "State of the Credit Union" Address
  - Backward looking vs. forward focus
  - Budget/variance focus
  - Lots and lots of details, numbers, and other "stuff"
- Decisions based primarily upon rate forecast, biases (i.e. speculation) instead of Balance Sheet Risk Profile

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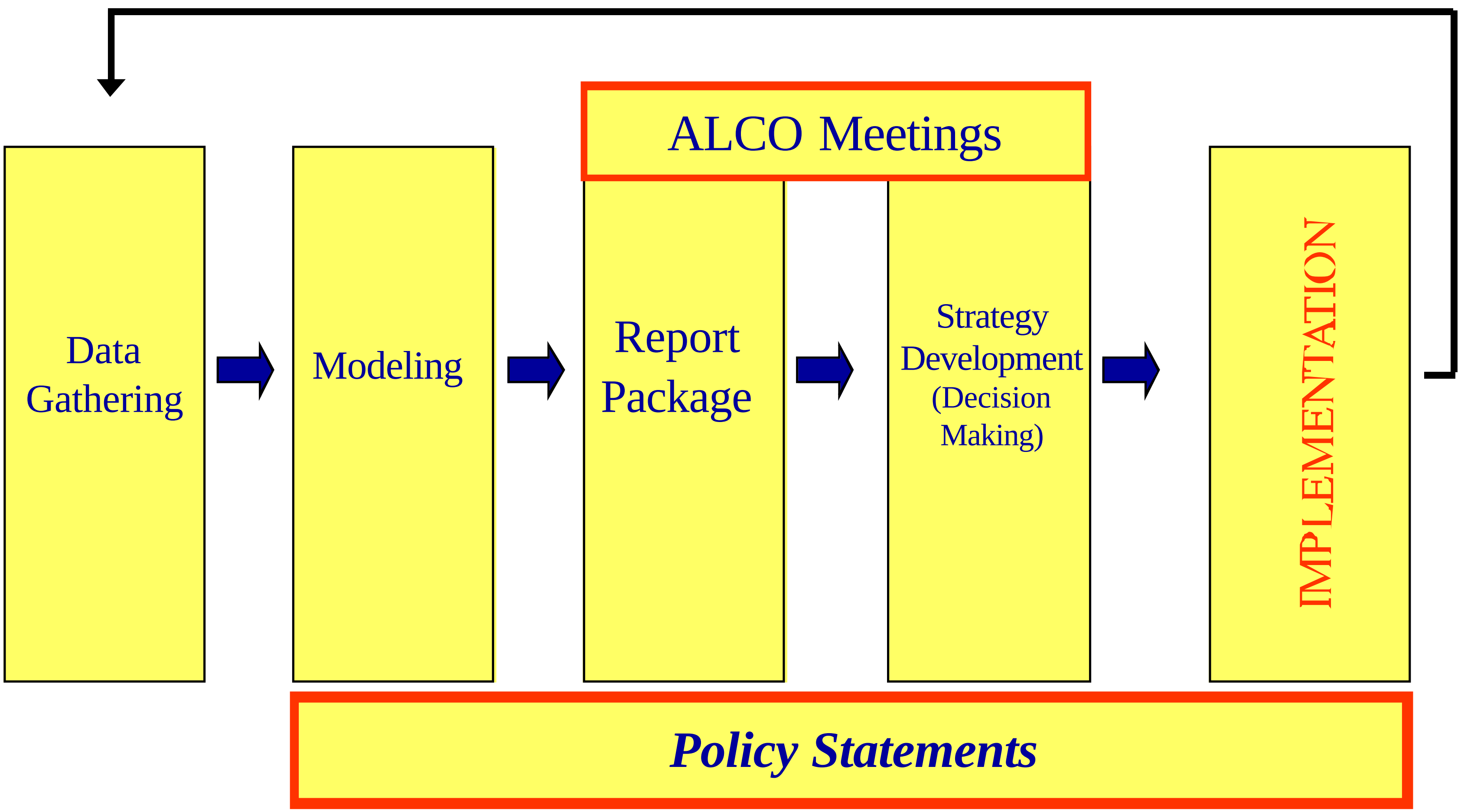
A successful ALCO

- Will challenge traditional wisdom
- Will look beyond local markets
  - Alternative Funding
  - Investment Alternatives
- Will continually educate management and directors
- Will focus on strategies that improve performance.
  - Increase current earnings
  - Increase Liquidity
  - Stabilize earnings

Develop a “Decision Oriented Process”



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