

Managing Interest Rate Risk: What Goes Down Must Come Up!



***Seven important ALM considerations
included in this quick read article!***

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If history is any guide, interest rates eventually will follow a kind of reverse Newtonian logic: What goes down must come up. In the meantime, credit union management and boards are keeping two questions uppermost in their minds: 1) When and how quickly will they turn around? and 2) What should we be doing now to prepare for the upturn?

A number of articles and advisories over the last several years have been sent to credit unions regarding the potential problems rising interest rates might pose, particularly in terms of mortgage exposures. In September 2003, NCUA released its Letter to Credit Unions 03-CU-15¹, cautioning credit unions about significant mortgage exposure. A January 2010 advisory², published by a consortium of financial regulators³, reaffirmed the caution. The advisory implored all financial institutions, including credit unions, to ensure that their interest rate risk management process is adequate for the level of interest rate risk on the balance sheet.

While credit unions have been hearing about potential problems associated with rising interest rates, interest rates currently remain at historically low levels. This situation is reminiscent of the boy who cried wolf. However, interest rates are expected to rise at some point in the future. So the question all should ask is, “Is our balance sheet well-positioned if interest rates were to begin rising tomorrow?” Being prepared is ultimately what NCUA regulators have been trying to drive home to credit unions for several years.

A strong asset/liability management program can help credit unions position the above question relevant to two others: How much risk does a credit union have to rising rates? And what is the credit union’s strategy when interest rates do change?

¹ National Credit Union Administration. Letter to Credit Unions No. 03-CU-15; [Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios](http://www.ncua.gov/letters/2003/03-CU-15.pdf). Issued September 2003. <http://www.ncua.gov/letters/2003/03-CU-15.pdf>

² Federal Financial Institutions Examination Council. [Advisory on Interest Rate Risk Management](http://www.ncua.gov/news/press_releases/2010/JR10-0107Attachment.pdf). Issued January 2010. http://www.ncua.gov/news/press_releases/2010/JR10-0107Attachment.pdf

³ The financial regulators consist of the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Office of the Comptroller of Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Financial Institutions Examination Council (FFIEC) Stat Liaison Committee.

Quantifying how much risk a credit union has to changes in interest rates is important, but understanding how and why credit union-specific risk exposures are embedded in the balance sheet is just as important. Without knowledge of these key issues, how can a credit union devise a sound strategy to address risk exposure and avoid undue pressure on earnings and capital? The answer is...it can't!

Most credit unions have seen their mortgage portfolios increase extensively over the past few years, and to a large extent, have funded this growth with relatively short-term funds (less than two years). The resulting long-term risk exposures have trended higher and higher, but why?

The answer becomes clear by evaluating the ALM reports or even the resulting weighted average lives (WAL) of assets versus funds. Growth in long-term assets – such as mortgages – that are funded with short-term deposits – such as one-year certificates – is causing a widening of the mismatch between the WAL of assets and liabilities. As the mismatch increases, risk increases. The heightened risk exposures shown in a credit union's Net Economic Value (NEV) analysis suggest long-term earnings and capital risk to rising interest rates.

When interest rates begin to rise, maturing deposits may need to be replaced at what will be higher prevailing interest rates, while the long-maturity mortgages remain on the balance sheet at the older, lower interest rates. This mismatch creates the pressure on earnings and capital – funding costs rise faster than asset yields, thereby reducing gross spread, return on assets, and projected capital contributions.

By employing a sound risk management process, a credit union can monitor risk exposures and then enact a balance sheet strategy to ensure that interest rate risk does not become overly burdensome and threaten earnings stability and capital adequacy.

Key elements of a sound risk management process include:

- Understand and be familiar with the assumptions used within the ALM process.
- Ensure that the analyses measuring interest rate risk are accurate and presented in a timely manner.
- Designate senior management responsibility for managing the credit union's risk exposure.
- Ensure that credit union personnel are capable of understanding **and** communicating the resulting risk exposures to examiners and the board.

Risk management is a continuous, never-ending process that involves: 1) identifying risk, 2) measuring risk, 3) monitoring risk, 4) reporting risk, and 5)

controlling risk. ALM is integral to a credit union's risk management process, as it facilitates the first four components of the process and enables the fifth component.

When properly tuned, an ALM model addresses the identification, measurement, monitoring, and reporting of interest rate risk exposures. Credit union senior management is ultimately responsible for making the decisions for controlling or managing that risk. For this reason, examiners want to ensure credit unions understand ALM and are able to incorporate the ALM results into their risk management and decision-making processes.

For larger credit unions, these functions may be performed in-house. However, for smaller credit unions, outsourcing the ALM function generally is a much more cost-effective solution. Whether ALM is performed in-house or outsourced, credit unions should ensure they satisfy the key elements addressed above.

For those that outsource the ALM function, consider the following questions: Does the provider offer the ability to discuss the analysis in depth to ensure full understanding of risk exposures? If not, where can a credit union acquire that knowledge? Likewise, for credit unions that perform ALM internally, does the credit union have the staff available to accurately decompose and understand the risk analysis?

When evaluating risk reports, keep these factors in mind:

- Be aware of the assumptions that drive risk analysis. Very important! Credit unions need to be familiar with and understand the assumptions used in the model, such as non-term share re-pricing, prepayments, etc.
- Make realistic assumptions. Ensure that assumptions made in the risk identification and measurement process are reasonable and reflect courses of action the credit union is likely to take.
- Identify and understand key risk exposures and drivers.
- Comprehend the products under consideration *before* adding them to the balance sheet.
- Remember diversification. Credit unions should diversify cash flows, collateral, and credit quality on the asset side of the balance sheet.
- Recall the risk/return trade-off. In order to improve earnings, risks must be taken *and managed*. Keep in mind that high returns come with high risk.
- Evaluate all products on a risk/return basis; never evaluate products solely upon return.

Whichever method a credit union chooses, the key point to absorb from the regulatory advisories is that credit union managers need to understand the ALM process and modeling used by their credit union. Finally, be aware of all the risks inherent on the credit union's balance sheet and understand how and why the components of risk arise and how they can be managed.

While measuring and managing interest rate risk may not make credit union managers' list of favorite hobbies, it can help shield credit unions from excessive risk exposures. The textbook definition of ALM is: "The process of structuring assets and liabilities so that earnings stability and capital adequacy is not materially affected by prolonged change in the level of interest rates."

This means that credit unions should use their knowledge of ALM and their ALM reports to manage the overall balance sheet composition to ensure that earnings and the subsequent capital contributions are not severely impacted by changes in interest rates. What has come down likely will go up.

While the Federal Reserve has indicated it does not intend to raise interest rates for an "extended" period, economists predict that when it does happen, the upward trend could be rapid. Credit union managers would benefit from understanding ALM capabilities and how ALM can be used to manage interest rate risk at their credit unions.

To access Southwest Corporate Investment Services' ALM resource library or to find out more about the ALM Service, please visit Southwest Corporate's website: www.swcorp.org. Over the past 20 years, Southwest Corporate's ALM team has performed more than 10,000 analyses for some 250 credit unions.

Mark DeBree manages the ALM Services group for Southwest Corporate Investment Services, where they provide interest rate risk analysis, model validations and core deposit analysis for client credit unions.