

Second Edition

ALM Spelled Out

By Bill Goedken

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 **CUES**



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A companion publication, *ALM Essentials: A CUES Director Briefing*, also by Bill Goedken, is available as a benefit to CUES Director members at cues.org/almdirectorbriefing/. For password assistance, please e-mail cues@cues.org.

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DEDICATION

This book is dedicated to my parents,
Vern and Bonnie Goedken.
Their patience, guidance and love
throughout life have been
the best a son could want.



About the Author



Bill Goedken is president/CEO of Goedken Consulting Group, LLC, Sedalia, Colo., a firm that services credit unions, banks and thrifts nationwide in a variety of subjects, including strategic planning, asset/liability management and profitability accounting. Before joining GCG, he founded Profitstar, Inc. and was the inventor of the *PROFITstar* asset/liability management model, which is widely used in financial institutions. Profitstar, Inc. was sold to Jack Henry & Associates, and Bill was the former group president of ProfitStars, a division within Jack Henry & Associates. ProfitStars services nearly 8,000

banks, credit unions, and savings and loans in the U.S., Canada, Australia, the Pacific Rim, the Caribbean and Central America. Bill is also a member of GTE Federal Credit Union, Tampa, Fla.

Bill holds bachelor's degrees in both accounting and finance and an MBA in finance from the University of Iowa. He also holds both CPA and CMA certifications and is a member of the American Institute of Certified Public Accountants, the Iowa and Nebraska Societies of CPAs, the Institute of Management Accountants and the Bank Administration Institute. Bill is past chairman of the CUES Supplier Member Advisory Committee. He has also attained a Level II Certification from AMIFs, a certification of knowledge and commitment about profitability accounting in financial institutions. In 2003, Bill was honored as the "Entrepreneur of the Year" by KPMG and the Omaha Chamber of Commerce and, in 2005, Bill was named "Outstanding CPA of the Year in Business and Industry" by the Nebraska Society of CPAs.

Before joining ProfitStars, Bill was a manager with accounting firm Deloitte and a staff accountant with Dee Gosling & Co. (now part of Clifton Gunderson & Co. CPAs). For seven years he was a senior officer of Farmers National Bancorp, a multi-bank holding company, and was also an adjunct member of its asset/liability management committee.

In past years, Bill has taught three semesters of financial management at the University of Iowa and has published numerous articles in the areas of asset/liability management, risk management and planning. He has spoken to thousands of bank executives, credit union executives and examiners (including the National Credit Union Administration) at various seminars about the subject. For five years, Bill was a continuing faculty member at the Southwestern Graduate School of Banking at Southern Methodist University, Dallas.

Bill is an avid snow skier, an avid poker player "for fun," a "not-so-avid" golfer, a second-degree black belt in karate and a commercial pilot. He is a volunteer pilot for the Angel Flight network.

How This Book is Organized

Finally, a practical guide on asset/liability management for credit unions!

This book will introduce you to the subject of asset/liability management (ALM). It is designed to be simple, informative and hopefully a bit entertaining. Above all, I have tried to write it in plain English. I will tell many stories—both of successes and failures in the subject. It is meant to start with the basics, and then go to an intermediate level of understanding on the subject of ALM. In the end, I have several primary goals for you:

1. Learn the basics of ALM to help better run the credit union.
2. Use ALM to reach the credit union's goals.
3. Better serve the credit union's members.

There are only a few requirements before you begin:

- **You have approximately 1–2 hours to read each section of this book.**
- **You understand the basics of credit union accounting (i.e. you know what a credit union balance sheet and income statement look like).**
- **You have a general idea of what some of the more important credit union CAMEL ratios are, such as net interest margin, return on assets (ROA), and net worth to assets, and how they are calculated.**
- **You have no “preconceived notions” of what ALM is.**

Sections and Chapters

The book is divided into five sections with the fifth section being all of the appendices. Each section is then divided into a number of chapters. Although each chapter has a specific topic, they are meant to be read in sequence. All chapters build upon the knowledge in the previous chapters. It is written for credit unions whose assets are less than \$10 billion. Very large credit unions (and banks) have more complex ALM issues than those faced by smaller credit unions, and I will not address those issues in this book.

Who should read this book?

Suggested Group	Section 1	Section 2	Section 3	Section 4
ALCO members	X	X	X	X
Credit union directors	X			
Management and directors responsible for strategic planning at the credit union	X	X		
Non-financial managers of the credit union	X			
Credit union employees involved with the financial function	X	X	X	
Credit union examiners	X	X	X	X
Consultants, accountants and vendors in the credit union industry	X			

SECTION 1

Keep it Simple Asset/Liability Management

Explains:

- What is ALM and why ALM is important.
- Discusses the ALM process and how it is integrated with long-range planning and the budgeting process.
- The balancing act between goals, risks and rewards, and strategies the credit union employs.
- Looks at the role of the asset/liability committee (ALCO) and board of directors in the ALM process.

SECTION 2

The Next Step: How ALM Works

Explains:

- A more advanced look at the ALM process.
- Different ALM measurement techniques.
- The ALM policy.
- Real-world examples of ALM strategies.

SECTION 3

Intermediate ALM and Credit Union ALM Strategies

Explains:

- Various risks facing the credit union.
- How ALM modeling and reporting can help the chance of success for the credit union's strategies.
- The gray areas of ALM.
- More advanced ALM modeling and credit union ALM strategies.

SECTION 4

Further Topics on ALM

Explains:

- How examiners view ALM.
- How to put the basic and advanced concepts together to help the credit union reach its goals and better serve the membership.
- A more advanced look at integrating long range planning, ALM and the budgeting process.
- Case studies of ALM.
- Where ALM is headed in the future.

SECTION 5

Appendices and Samples to Help You with the Concepts Learned

Appendix A shows a sample asset/liability policy and a sample of minimum/maximum values of ALM policy limits.

Appendix B gives a recap of the various ALM measurement techniques, what they are for and how they are computed.

Appendix C shows sample ALM reports for less complex credit unions.

Appendix D shows a more sophisticated approach to ALM reports for more complex credit unions.

Appendix E gives a recap of the pros and cons of different ALM services.

Appendix F is a quiz on the concepts learned in this book. You can score yourself and determine whether you need additional training on the subject.

Appendix G is a glossary of key terms.

Appendix H contains references to additional reading on the subject.

A Special Thanks

This book would not be possible without a special thanks to the people at ProfitStars, a Jack Henry Company. ProfitStars is the provider of the *PROFITstar* asset/liability management system used by many credit unions, and some of the illustrations in this book come directly from the graphical output of *PROFITstar*. For more information, go to www.profitstars.com.

Forward

As many in the industry know, I love to fly and have been flying since I was 14. Years ago on one particular flight, I set out from Iowa City, Iowa, to Omaha, Neb., (about 250 miles) to meet with a client about their financial situation. I had checked the weather in the morning, and it was forecasted to be near perfect—unseasonably warm for late December just before Christmas. Temperature was forecasted to be in the high 50s, good visibility, light winds and very few clouds.

After I took off, I was flying west listening to a recorded weather report en route just over Des Moines. The controller must have had a sense of humor as he mixed in singing holiday cheer with his report “and skies are clear with visibility 10 miles... Fa la la la... la la la la.” There were no worries. It was going to be a great day.

My business meeting in Omaha took longer than expected, and just after sunset I again took off this time heading east back to Iowa City. I did not check the weather report, confident that the forecast would hold for the day. Besides, it was only a 90 minute flight, and I was looking forward to spending Christmas with my girlfriend and family.



The air was smooth with clear skies above me starting to be filled with stars. As the flight moved from dusk to night, just past Des Moines, one of my radios quit working (this was a fairly new airplane!), but I still had one left to continue on the journey. Around Newton, Iowa, I looked ahead and saw no lights indicating the cities of Iowa City, and neighboring Cedar Rapids to the north. I thought it was odd. Normally I could see the lights of the cities very clearly at night. I looked straight down and still could see farm lights and the town of Grinnell—but no lights ahead.

I first thought it could be a blackout. But this was eastern Iowa, not like New York or California with their frequent blackouts. I thought it was curious and pressed on. As I got close to Iowa City, my remaining navigation radio told me I was near the airport but again no lights. I radioed a call to the Iowa City airport and got no response.

Then it dawned on me—eastern Iowa was enveloped in fog. The sky was perfectly clear above me, and I could see stars, but a layer of fog had shrouded the entire eastern portion of the state. I could not land in these conditions. Fuel was starting to become an issue, so I immediately called Cedar Rapids and asked for weather from Cedar Rapids back to the west. Cedar Rapids was socked in with fog and had zero visibility, so was Moline and points east all the way to Chicago. Des Moines was clear but was expecting fog very soon. I turned the plane around and raced back to Des Moines.

I did make it to Des Moines—barely. Des Moines became instrument conditions (weather conditions that require a pilot to rely on instruments rather than relying on visual references) minutes after landing, and I was taxiing to the parking area. One hour later the airport was closed due to fog. Eastern Iowa was enveloped in fog for nearly three days, and driving was even hazardous since visibility was near zero. I didn't want to rent a car and risk driving on the interstate. I spent Christmas that year in a hotel.

This flight taught me one thing: to be prepared. You never know what might be coming your way. Asset/liability management is all about preparation. It is the early warning forecast—updated constantly—to tell you about what is around the corner.

Occasionally I meet a manager or a board of director at a credit union who tells me that the only reason they do asset liability management (ALM) is “to keep the examiners off our backs.” I will submit to you that this is what we pilots call “seat of the pants flying.” As long as conditions are good, you might be OK. But when storm clouds rise, it is best to know what you are doing and be prepared.

One theme I would like to impress upon you as you read this primer is to ask yourself: Whose money are you safekeeping? It's the members! To use an analogy, a good doctor looks at blood pressure, blood sugar levels, EKG results, cholesterol levels and many other measures to formulate an indication of a person's health. The doctor then asks you if you are active in an exercise program. Why? To help ensure your health continues. ALM looks at many measures as well to look at the credit union's health. A healthy credit union is good for the membership! So it is in the members' best interest that you watch out for “their health.”

SECTION 1

Keep it Simple Asset/Liability Management





A Quick Summary of ALM

Asset/liability management is a **critical** part of the credit union financial management process. Credit unions that employ ALM effectively tend to be higher performing and serve their members better than credit unions that view ALM as a necessary evil. ALM alone will not guarantee that you will be a higher performing credit union, but it does greatly increase the credit union's chances of success. So if you want to have the potential of being a higher performing credit union, you must take ALM seriously.

Why Do I Need ALM?

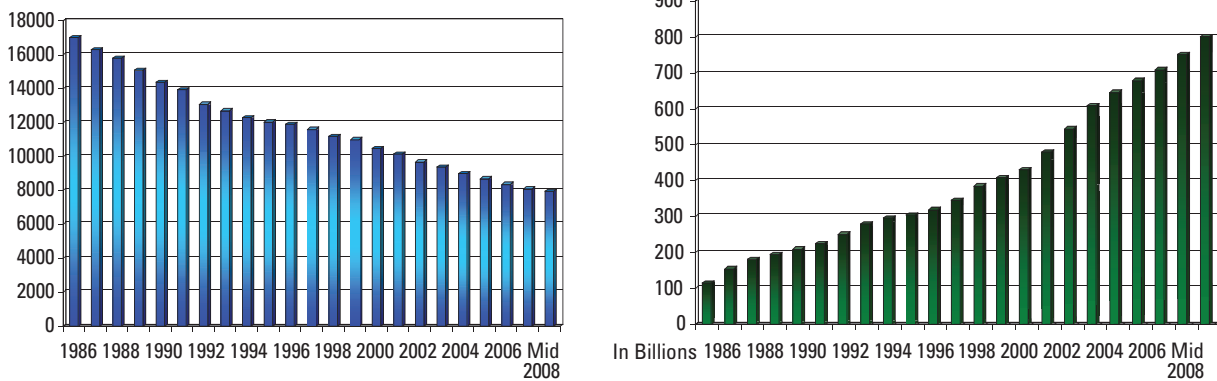
To quote an unnamed expert in the credit union industry: "Because it's the members' money, stupid!" Too often we think the assets and liabilities of the credit union belong to the credit union. No! The assets and liabilities of the credit union are the members' property. The management and the board of directors of the credit union are simply safekeeping the accounts for the members. Since a top goal of all credit unions is to promote safety and soundness for its membership, ALM helps to ensure that goal is being met.

Let's review several facts. During the past two decades, the credit union industry has enjoyed an annual average growth rate above 11 percent in total assets. Total deposits and total membership have also increased. However the number of credit unions in the U.S. has declined steadily since 1985. Since total assets have increased and total credit unions have decreased, individual credit unions have grown at a much faster pace than the 11 percent figure. Figure 1.1 illustrates these points.

KEY POINTS IN THIS CHAPTER

- If you're reading this chapter, it must mean you are short of time and the examiners are coming to your credit union soon. You want to cut to the chase. It also serves as a great general introduction to the concepts presented later in the book.
- Asset/liability management is the process of coordinating actions to control the credit union's risks and reach its financial goals.

Figure 1.1 Number of U.S. Credit Unions and Total Assets of U.S. Credit Unions



Number of U. S. Credit Union

U.S. Credit Unions—Total Assets

Because of these factors, more and more members have a larger financial interest in credit unions. Many members consider their credit union to be their primary financial institution, or PFI, and have the vast majority of their personal loans and deposits at these credit unions. The members are relying on the board of directors and the employees of the credit union to help them with their financial situations! Asset/liability management helps ensure you “don’t let the members down.”

Who is in Charge of ALM?

In a broad sense, everyone at the credit union is in charge of ALM. Sooner or later, all actions taken at the credit union (whether it is making loans, member service activities or building a branch) are ALM activities. These activities all affect the balance sheet (assets, liabilities and net worth) and the income statement. More specifically, the board of directors is ultimately responsible for guidance on the risk/return levels expected at the credit union. The asset/liability committee (ALCO), usually composed of senior level credit union management, is in charge of the day-to-day ALM activities. The board of directors usually oversee the ALM process on a broad basis, but the ALCO performs the “nuts and bolts” of ALM. The ALCO reports ALM results to the board of directors on a periodic basis, usually once a month or once a quarter.

What Else do I Need?

All of the items below will be discussed at length in later chapters of this book. This is a short checklist of the bare bones minimum you need for ALM at your credit union.

- 1. Set clear goals for the credit union.** Goal setting is part of the credit union’s long range strategic planning process. If the credit union’s goals

and objectives are clear, understood, and perceived to be achievable by the ALCO and the credit union's employees, chances are ALM will be much easier. In order for goals to be clear, they must be measurable, have a time dimension and be reasonable.

2. Be knowledge about the ALM process. Most ALCO members should know ALM very well. The board of directors should have a good, general understanding of ALM and at a minimum know the basics. If not, further education is required. Also, ALM is a subject that constantly evolves. Thus, it is expected that the knowledge level of the credit union personnel responsible for ALM evolves as well. Ongoing education is a must. It is also important to note that ALM is a process. This involves much more than reporting on ALM or just having an ALM policy.

3. An asset/liability management policy. The credit union's ALM policy outlines the acceptable risk/return levels, duties of the ALCO and the board of directors, and general procedures for ALM. It is suggested to keep the policy simple, yet provide clear guidance to the credit union.

4. A mechanism to measure risk/returns of ALM. The board of directors and the ALCO need a reporting mechanism to look at the past, present and future position of ALM. Many times this is the result of a commercially available ALM model or service option from a vendor. The reporting mechanism should clearly show if the credit union is in compliance with the ALM policy limits, and expose opportunities for the credit union to take further action. One of the concepts I will introduce in later chapters is the **red zone**. The red zone indicators are the limits from the ALM policy. The reporting mechanism should clearly show the various red zones and whether your credit union is in compliance.

5. A consistent management of the process. ALM is NOT a measure-and-forget exercise. Constant and consistent management of the process is a must. The ALCO is the group within the credit union that coordinates the ALM process. From time to time, they report a summary of the ALM results and decisions to the board of directors.

6. A great attitude. It is my belief that if your credit union views ALM as a necessary evil or performs ALM just to appease the examiners, then the credit union's chances for success will greatly decrease. Nothing beats a great attitude when dealing with this subject.

7. Be aware of some differences between ALM as viewed by the examiners and ALM as viewed by the credit union. The examiners have a slightly different view of ALM than the day-to-day business of managing the ALM process. Both views are correct, but they each have different intents. A later chapter explains why.

8. Know that ALM is one step in the financial management process. ALM is only part of the credit union's coordinated financial management process. Other areas, such as long-range strategic planning and the budgeting process, need to be added in order for ALM to be truly

It is my belief that if your credit union views ALM as a necessary evil or performs ALM just to appease the examiners, then the credit union's chances for success will greatly decrease.

successful. It is the integration of these processes that helps ensure not only the safety and soundness of the credit union but also that the short-term and long-term goals of the credit union are being met.

