February 2018

Economic Update

The Fed left its benchmark interest rate unchanged at its January 31st meeting, although indicated a rate hike at its next meeting in March was likely. Expectations are that the economy will continue to grow at a solid rate and the labor market will continue to improve. This was Janet Yellen's last meeting, concluding her 4-year term as chairwoman. Stepping up is Jerome Powell, a Fed governor since 2012.

ALM 101: Interest Rate Risk

Asset Liability Management (ALM) is the process of planning, controlling, and monitoring financial performance and risk. My experience in working with credit unions and conducting financial literacy training is that the primary difficulty in understanding ALM is terminology. Focusing on the interest rate risk (IRR) component of ALM, we can crack the code of ALM Speak to understand why this is so important in credit union management.

Interest Rate Risk (IRR): Impact of changing interest rates on earnings and net worth, IRR is the risk that a credit union's earnings and capital will decrease as market interest rates change. This risk generally occurs because a credit union may have a disproportionate amount of fixed and variable rate instruments on either side of the balance sheet.

Net Economic Value (NEV): NEV is measured by calculating the present value of assets minus the present value of liabilities, plus or minus the present value of the expected cash flows on off-balance sheet instruments. What does that mean? NEV simply forecasts the impact of changing interest rates on a credit union's net worth.

GAP Analysis: Measures the maturity and repricing difference between assets (loans and investments) and liabilities (deposits and borrowed funds). If assets and liabilities are comparable in maturity terms and abilities to reprice, the impact to earnings and net worth will be minimal.

The primary goals of IRR management are to avoid extreme fluctuations in net earnings, maintain a relatively constant net interest income over time, and to preserve net worth. Most credit unions are liability sensitive, meaning liabilities are repricing and/or maturing faster than assets. This is because mortgages and other loans are longer term than member deposits . As a result, as market rates increase, deposits reprice faster than loans, and net interest income decreases. The degree of this change in income, and ultimately net worth, corresponds to the level of interest rate risk.

A 300-basis point instantaneous and parallel rate shock is used by Examiners to evaluate IRR. This assumes that the balance sheet remains static (no growth or changes in composition) and all interest rates that can adjust will reprice immediately by a proportional amount. The cumulative effect is measured twelve months out to determine the amount of interest rate risk of a specific balance sheet. NCUA considers this a reasonable stress test.

Click here for more information, including the benefits of static versus dynamic simulation modeling: http://www.cucfo.com/alm101irr.pdf

Peggy's Philosophies – Work Life Balance

I was fortunate to work for a visionary credit union CEO early in my career. Peggy was a firm believer in family and work life balance. She urged me to take time to attend my children's school events and encouraged "mental days off" to recharge. After putting my life on hold for the past two years while working 60 to 80 hours a week, I have come to appreciate Peggy's value of employees. Employee retention improves profitability and as a business strategy it makes sense.

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CFO in a Box

Debra Taylor Templin, CPA has more than 25 years' experience within the credit union industry, including ten years as Chief Financial Officer and seven years as Chief Executive Officer. As a virtual CFO, Debra is able to deliver high level results that blend traditional values with progressive needs.