BALANCE SHEET SOLUTIONS
an alloya company

5 Ways to De-Mystify ALM for your Board

By Kris Muller, CFA, Senior Portfolio Manager, Balance Sheet Solutions, LLC

Does your board have a hard time with Asset Liability Management (ALM) concepts? Many credit union board members come from non-financial backgrounds and some of the concepts in risk modeling may not be easy to understand at first. Yet, many of the key elements of the reports can be compared to our daily lives.

The following five suggestions will help make ALM more tangible for your board.

1. Rate Shocks

The use of “instantaneous, parallel, permanent interest rate movements” may seem extreme in the current environment, but shocking the balance sheet with these moves is a regulatory requirement for credit unions. To comprehend this idea, many times I use the statement “you wake up tomorrow and interest rates are suddenly 1.0% higher” (or 2.0% etc.). Then carry this through to how their world has changed. On the personal liability side, their existing mortgage or car loan rate will look pretty good, while assets such as their deposits may begin to earn higher rates of interest. It is the exact opposite for the financial institution – the fixed rate loans on the credit unions balance sheet will look worse in a higher rate environment and higher rates will cost extra expenses on deposits. Once the board member can learn to switch their perspective from being a member to management, things may become clearer.

2. Net Interest Income

This is probably the easiest concept to explain to a board member. Net interest income is equivalent to their paycheck. There are some cash flows that are not considered, such as loan pre-payments and fees, but the basic inflows and outflows from the balance sheet are represented in this figure.

3. Net Income

Continuing on the personal income theme, the credit union’s net income is equivalent to an individual’s disposable income after fixed costs are paid (mortgage, car loan, utilities). For many individuals, this is the amount that will go into savings, just like the credit union will apply this net income to capital.

4. Net Economic Value

Net Economic Value (NEV) can be translated to mean “what are you worth today?” This is simply the market value of one’s assets (house, car, savings) minus the market value of their liabilities (all of one’s debts). One’s NEV will be impacted by changes in interest rates depending on if they will benefit from a rising rate environment (high level of savings) or be negatively impacted (floating rate loans).

Again, it is the reverse for credit unions. A large number of floating rate loans will be a benefit to the credit union in a higher rate environment, whereas a high concentration of fixed rate loans will be a detriment.

5. Capital

Simply put, capital is the credit unions savings account. In good years, one contributes money to their savings account (capital). In bad years, they have to dip into savings to make ends meet. This is also the account that is reviewed for major projects, such as a new branch. The credit union must maintain a certain ratio of capital to assets to stay within regulatory guidelines. Just like their own personal savings, capital preservation must be a top priority to move the credit union into the future.

While there are many more aspects to ALM, it is important to remember that board members who do not deal with this subject on a regular basis may need some help in becoming familiar to the concept. Applying everyday comparisons may help start them down this path.