Dear Manager and Board of Directors:

In 1999, the National Credit Union Administration (“NCUA”) issued the first of a series of Letters to Credit Unions providing guidance on asset liability management (“ALM”). At that time NCUA also began to pilot improved examination procedures to better evaluate a credit union’s balance sheet management. This letter explains the pilot program and provides an overview of the new procedures that will be used after January 1, 2001.

Pilot Program.

The implementation of improved ALM examination procedures consists of three phases. The first phase of the ALM examination pilot program had three objectives. First, develop specific review procedures for evaluating a credit union’s ALM. Second, establish criteria for allocating examiner time to credit unions with potentially greater risk exposure. Third, develop methods to evaluate a credit union’s internal risk assessment. We completed this phase in 1999.

In the second phase, spanning the last quarter of 1999 through the first quarter of 2000, NCUA and state examiners used preliminary ALM examination procedures in 25 credit unions, ranging in size from $9 million to more than $400 million in assets. Extensive revisions to these procedures were made throughout this phase in response to the suggestions from examiners and participating credit unions. Draft procedures and associated guidance were distributed to all NCUA field staff in June 2000. Throughout the remainder of 2000, examiners will test these procedures and recommend additional refinements.

1 Letter to Credit Unions #99-CU-12, dated August 1999, “Real Estate Lending and Balance Sheet Risk Management”
The final phase is to incorporate the procedures and guidance into the examination program in January 2001. Additionally, it is our intent to make the ALM Questionnaire and supporting work papers available publicly early next year through the NCUA web site at: www.ncua.gov.

**ALM Review Procedures.**

Using a risk-based approach, consistent with the potential risk and complexity of the credit union’s balance sheet, an examiner will establish the scope of a prospective credit union’s ALM review. Credit unions without real estate loans or complex investments will likely need only simple ALM procedures to control their balance sheet risk. Accordingly, examiners would typically need only a limited scope to determine the adequacy of the credit union’s balance sheet management.

Credit Unions with real estate loans, complex investments, or both should give more attention to ALM. In these cases, the examiners will use a streamlined method to measure the potential risk from these assets to help determine the scope of the ALM review. This measure entails devaluing all fixed-rate mortgage loans, variable-rate mortgage loans, and investment securities by certain percentages. This provides the examiner with a simple measure of the potential devaluation these assets could incur during a 300 basis point, parallel shift in interest rates. If the results indicate the credit union’s capital is unlikely to be sensitive to an interest rate shift, the examiner will typically look at some general areas of the credit union’s ALM and will not conduct a detailed evaluation of the credit union’s balance sheet management. If the examiner chooses to investigate the specifics of the credit union’s ALM management, it will likely be in limited areas. Otherwise, the examiner will use another measure to understand the credit union’s potential interest rate sensitivity.

The examiner may use NCUA pricing tables to better analyze the potential sensitivity of the credit union’s mortgage loan portfolio. Although the pricing tables will remain a general measure of the credit union’s risk exposure, they will permit the examiner to differentiate the price sensitivity of a credit union’s mortgage loan portfolio by certain characteristics (e.g., remaining time to maturity, loan rate, repricing interval). The tables will be made available to credit unions on the NCUA website early next year.

If this calculation shows significant potential risk it would signal the need for a detailed review of the credit union’s ALM. These calculations, however, will only serve as examiner guidelines. There may be a number of reasons (e.g., a credit union’s size, the stability of its management or changes in its field of

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2 Complex investments are defined in §703.70 and §703.90 of the NCUA Rules and Regulations (12 CFR 703)

3 As required in §703.90.
membership) that may cause an examiner to choose to conduct a more thorough analysis, although the calculations suggest a more limited scope.

Whether the examiner performs a general or detailed review the evaluation will focus on a credit union’s policies, strategic planning, liquidity, ALM-related management committees, infrastructure, and staff and management knowledge. In addition, the examiner will evaluate the credit union’s risk measurement system and the underlying assumptions used in the risk assessment.

**Examiner Training.**

NCUA recognized that refinement of the ALM segment of the examination program would require substantial education of staff and the agency is now involved in a large effort to accomplish this objective. During this past summer all federal examiners received an introduction to the new ALM exam procedures. We anticipate most field staff will receive additional training during the remainder of 2000 and throughout 2001. State examiners are also receiving training on the new procedures.

NCUA has also begun specialized training for some examiners. By year-end approximately 100 federal examiners and 25 state examiners will have received intensive classroom training using the new procedures. Some of them will have also received on-site training this year. Substantially more examiners will receive this specialized training in 2001 and all examiners will receive some additional training using these procedures over the next 18 months. The examiners with advanced training, and the more highly trained regional investment specialists, will regularly focus on the more complex credit unions and those with the greater potential risk and will be used as a resource by the rest of the examiner staff.

**Relationship of Statutory Net Worth Requirements and Balance Sheet Management Review.**

There is some confusion as to the relationship between the calculation to determine the scope of the ALM review and the statutory net worth requirements\(^4\). The emphasis on balance sheet risk management exam procedures is unrelated to the statutory net worth obligations. Net worth focuses on "book" net worth and Part 702 requires credit unions to provide balance sheet information on a book value basis. Credit union risk assessment addresses the fair value of balance sheet components and the potential impact of economic and financial market changes on the credit union’s income and fair value of the balance sheet.

Finally, we do not instruct our examiners to set capital standards for credit unions. While examiners will evaluate the sensitivity to interest rate risk using

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\(^4\) As set forth in §1790d of the Federal Credit Union Act and Part 702 of the NCUA Rules and Regulations.
asset valuation methods, this exercise is intended to determine the scope of review and not measure interest rate risk or determine minimum capital standards. We have emphasized this point to our staff and will continue to do so during enhanced ALM education seminars.

Asset liability management continues to be an evolving field. NCUA will refine its methods of assessing a credit union’s risk estimates and is committed to continuously train staff to keep pace with these changes. As NCUA’s procedures are revised the changes will be shared with the credit union community.

Sincerely,

/S/

Norman E. D’Amours
Chairman
National Credit Union Administration Board