Developing a Realistic ALM Policy
And Policy Limits
Feb 26, 2008

“Developing a Realistic ALM Policy and Policy Limits”

Tuesday Feb. 26, 2008

FMS Webinar Series

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Polling Question

Please select your level of experience with today’s topic:
Objectives of this session on ALM:

- Make sure we understand the intent of ALM at Financial Institutions
- Establishing an Effective ALM policy
- Evaluating and setting ALM policy *limits*
- Best practices in communicating with the ALCO, Board of Directors and Regulators

Financial Planning Process

- Long Range Outlook
- Asset/Liability Mgt.
- Budgeting Process
- Org. Profitability
- Product Profitability
- Customer Profitability

Strategic

Feedback

Tactical
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Banks less than $1 Billion – True Profitability

Basis Points

Return on Average Assets (ROA)

95 96 97 98 99 00 01 02 03 04 05 06 07

-160 -150 -140 -130 -120 -110 -100 -90 -80 -70 -60 -50 -40 -30 -20 -10 0 10 20 30 40 50 60 70 80 90 100 110 120 130 140

Source data: FDIC

Banks less than $1 Billion – True Profitability

Basis Points

Return on Average Assets (ROA)

ROA less Fees and Other Income

95 96 97 98 99 00 01 02 03 04 05 06 07

-160 -150 -140 -130 -120 -110 -100 -90 -80 -70 -60 -50 -40 -30 -20 -10 0 10 20 30 40 50 60 70 80 90 100 110 120 130 140

Source data: FDIC
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Banks $1 Billion to $10 Billion – True Profitability

Return on Average Assets (ROA)

ROA less Fees and Other Income

Basis Points

95 96 97 98 99 00 01 02 03 04 05 06 07

140 90 40 0 -10 -60 -110 -160

127

-65

Source data: FDIC

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Thrifts less than $1 Billion – True Profitability

Return on Average Assets (ROA)

ROA less Fees and Other Income

Basis Points

95 96 97 98 99 00 01 02 03 04 05 06 07

140 90 40 0 -10 -60 -110 -160

56

-119

Source data: FDIC

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Asset/Liability Management (ALM)
The Process of Evaluating and Executing Actions to Control your Risks and Reach your Financial Goals.

In other words:
Use ALM to enhance your institution’s Business Model!
Major Risks - Measured

- Credit Risk
- Liquidity Risk
- Interest Rate Risk
  - Earnings at Risk
  - Capital at Risk (NEV)
- Remember – Financial position is equally important!

Definitions of Risk

1. **Credit Risk** - The Risk to earnings or capital (E/C) from creditors not paying obligations

2. **Liquidity Risk** - The Risk to E/C from the inability to meet obligations when due without incurring unacceptable losses
Definitions of Risk

3. Interest Rate Risk

- Risk to Earnings – The Risk to the Income Statement from movements in Interest Rates
- Risk to Capital - (Price, Valuation or Market Risk) - The Risk to Capital (because of changes in Asset and Liability Values) arising from movements in Interest Rates or Market Conditions

Other Risks that affect Financial Institutions:

- Business/Strategy Risk
- Reputation Risk
- Legal Risk
- Operations Risk
  - Business Continuity Plan
- Compliance Risk
- In the future, ALM will be comprehensive enough to cover all of the risks above
  - This is called “Enterprise Risk Management”
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Key Findings - Examiners want to know the following:

- Do you understand what ALM is?
- Are the proper items in place?
  - ALCO
  - ALM policy with policy limits
  - Education plan for ALCO and Board
  - Validation of results
  - Measure and Manage: Credit, IRR on Earnings, IRR on Capital, Liquidity Risk, and Financial Position
- Do you know how ALM and other strategies may affect your Institution?
- Can you explain the results?

What the ALCO & the Board of Directors must do:

- Board of directors are ultimately responsible for safety and soundness of the Institution (ALM!)
- ALCO is delegated to day to day duties
- ALCO measures and manages the ALM process
- The board of directors needs to:
  - Look at the ALM position of the Institution once at least once a quarter
  - If outside the policy limits (RED ZONE) ask questions!
  - Review the ALM policy, with policy limits, once a year
  - Ongoing education – quarterly or annually
  - Understand the role of ALM to the Institution and its customers/membership
What is it we are really trying to do?

- Take advantage of opportunities and beat the competition!
- Stay out of trouble!

Sample Institution
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An ALM Policy That Makes Sense:

- KISS!
- Looks at the intent of ALM, and its role in the Institution
- Financial position is measured through ALM
- Needs to Address the Main Risks:
  - Credit Risk
  - Liquidity Risk
  - IRR on Earnings
  - IRR on Capital
- Talk about the role of the:
  - Board of Directors
  - ALCO

An ALM Policy That Makes Sense:

- Addresses the ALM measures in an appendix
- Other policy areas that are often overlooked:
  - Ongoing education
  - Model and ALM Process Validation
  - Alternative funding sources
  - Coordination with other policies
  - Coordination with your strategic plan
- Be careful of the words you choose!
- Appendix examples:
  Pick either sample 1 or 2
Usual sections in an ALM Policy:

1. Definition of Asset/Liability Management
2. Purpose
3. Responsibilities:
   - Board of Directors
   - Asset/Liability Management Committee (ALCO)
4. Primary Objectives of ALM
5. Duties of ALCO
6. ALCO Meetings
7. ALCO Membership
8. Risks and other Financial Measurements
   - Liquidity and Funds Management
   - Interest Rate Risk on Earnings Management
   - Interest Rate Risk on Capital
   - Credit Risk and Credit Quality
   - Other Risks
9. Annual Budget and ALM
10. Capital Planning
11. Compliance with Laws and Regulations
12. Other Matters
13. Appendix – ALM Policy Limits

Basic ALM Measurement Techniques

<table>
<thead>
<tr>
<th>Basic/Intermediate ALM Measurement Technique</th>
<th>“Bill’s Rating”</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) CAMELS and Other Ratios</td>
<td>A-</td>
</tr>
<tr>
<td>2) Maturity Gap</td>
<td>B+</td>
</tr>
<tr>
<td>3) Repricing Gap</td>
<td>C</td>
</tr>
<tr>
<td>4) Income Simulation for Earnings at Risk</td>
<td>A-</td>
</tr>
<tr>
<td>5) Net Economic Value (NEV, EVE, MVPE)</td>
<td>B</td>
</tr>
<tr>
<td>Understanding ALM Measurement and Management to maximize value and service to the Customers or Members</td>
<td>A+</td>
</tr>
</tbody>
</table>
### ALM Policy Limits Examples

<table>
<thead>
<tr>
<th>Risk and Financial Management Category</th>
<th>Lower ALM Policy Limit</th>
<th>Upper ALM Policy Limit</th>
<th>Frequency of Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit: Delinquent Loans to Total Loans</td>
<td>0.3%</td>
<td>2.5%</td>
<td>Monthly</td>
</tr>
<tr>
<td>Liquidity: Cumulative 1 year Maturity Gap</td>
<td>60%</td>
<td>200%</td>
<td>Monthly</td>
</tr>
<tr>
<td>IRR on Earnings: Projected 36 month ROA, minimum for ALM</td>
<td>&gt;.30%</td>
<td>N/A</td>
<td>Quarterly</td>
</tr>
<tr>
<td>IRR on Capital: Minimum EVE to Asset Ratio</td>
<td>5.0%</td>
<td>N/A</td>
<td>Quarterly</td>
</tr>
</tbody>
</table>

### Questions?

- Select *1 now to ask a live question through the phone  
  OR  
- Type your question into the chat box in the lower left corner of the screen and click on the “Send” button located right below the box.
What is the "Red Zone?"

- Your ALM Policy Limits!
- A philosophical and/or regulatory limit of where you do not want results to be.
- This needs to be discussed between management and the board of directors.
- Can show it in tabular format or graphically.
- You might have a "yellow zone" which is a "warning track". (This is NOT in the policy)
- Tip – if results are consistently in the Red Zone you should be worried about the institution!

One ALM Measurement Technique – CAMELS Ratios

- These are easy to compute and the examiners like them.
- The main point is to look at these over time (past, present, future).
- Lots of ratios, keep it simple in the beginning.
- Look at the trends and the RED ZONE!
- If in the RED ZONE – what do you do?

ASK LOTS OF QUESTIONS!
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Capital to Assets

29 Source: NCUA, FDIC, OTS

Capital to Assets

30 Source: NCUA, FDIC, OTS
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Interest Rate Risk – Steps on how to measure:

1. Project out the institution’s plan for the future.
   (Balance sheet, deposit growth, loan growth, etc.)
2. Look at different interest rate scenarios for the future
   - Examiners like to see a “shock”
   - Alternative – rates are “ramped”
3. Then look at IRR on Earnings (effect on the Income Statement)
4. Then IRR on Capital (effect on the balance sheet and net worth)
   - Note IRR on Capital is still evolving (and controversial)
   - Comes up with NEV (Net Economic Value)

Prime Rate “Shock”
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Prime Rate “Ramp”

One ALM Measurement Technique – Income Simulation for IRR on Earnings

- Income Simulation looks at Margin and/or ROA and shows how sensitive it is to interest rates.
  - Measures **Interest Rate Risk on Earnings**
  - More sensitive, more risk.
  - Compare results against the policy limits.
  - Don’t go in the Red Zone!

- Examiners like this technique, so do most CFO’s
  - Your Strategic Plan and Balance Sheet structure can greatly influence your risk.

- Bottom line – A good technique for Interest Rate Risk on Earnings
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Earnings at Risk with a rate “Shock”

Note: This is a full “Rate Shock” scenario. Rate Ramps usually show less risk.
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Earnings at Risk with a rate “Shock”

FLAT rates ROA
Projected ROA if rates
RISE +300 BP

Note: This is a full “Rate Shock” scenario. Rate Ramps usually show less risk.
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Earnings at Risk with a rate “Shock”

Note: This is a full “Rate Shock” scenario. Rate Ramps usually show less risk.

Earnings at Risk “Shock”

Note: This is a full “Rate Shock” scenario. Rate Ramps usually show less risk.
Questions?

- Select *1 now to ask a live question through the phone
- OR
- Type your question into the chat box in the lower left corner of the screen and click on the “Send” button located right below the box.
Another ALM Technique:
Net Economic Value for IRR on Capital:
1. IRR on Capital is still controversial
2. Instead of Book Value on the Balance Sheet, it “Fair Values” the Balance Sheet using Discounted Cash Flow techniques
3. Net Economic Value = NEV. This is what is left after assets and liabilities are “fair valued”
4. EVE, MVPE: the same thing
5. If interest rates change, the NEV changes.
6. Examiners want to see if NEV changes too much! (Is there any left?)

Balance Sheet – Book Value Concept

Book Concept (in 000’s):
Assets - Liabilities = Capital

100,000 - 91,000 = 9,000

Note: Net Worth To Assets = 9.00%
Fair Value Concept (IRR on Capital)

Fair Value Concept (in 000’s):

\[\text{FV Assets} - \text{FV Liabilities} = \text{NEV}\]

Note: NEV = Net Economic Value (also EVE and MVPE)

1. Initial Scenario:
   - FV Assets: 96,000
   - FV Liabilities: 83,500
   - NEV: 12,500
   - Note: NEV to Assets = 13.02%

2. Scenario with Rate Increase:
   - FV Assets: 92,000
   - FV Liabilities: 85,000
   - NEV: 7,000
   - Note: NEV to Assets = 7.60%
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**Fair Value Concept (IRR on Capital)**
**Rates DOWN -300 Basis Points**

**Fair Value Concept (in 000’s):**

\[ \text{FV Assets} - \text{FV Liabilities} = \text{NEV} \]

- FV Assets: 105,500
- FV Liabilities: 91,000
- NEV: 14,500

Note: NEV = Net Economic Value (also EVE and MVPE)

Note: NEV To Assets = 13.74%

---

**NEV to Asset Ratio:**

\[ \frac{\text{NEV}}{\text{FV Assets}} = \frac{14,500}{105,500} \]

- NEV / FV Assets: 13.74%

Note: NEV = Net Economic Value (also EVE and MVPE)
Net Economic Value and Cap. to Assets Ratios:

NEV to Assets vs. Book Net Worth to Assets

Net Economic Value and Cap. to Assets Ratios:

NEV to Assets vs. Book Net Worth to Assets
Net Economic Value and Cap. to Assets Ratios:

NEV to Assets vs. Book Net Worth to Assets

Measuring Credit Risk:

- There are many measures of credit risk
- The important point is too look at credit risk with the other risks (Interest Rate Risk, etc)
- Sample Measures:
  1. Delinquent Loans to Total Loans
  2. Average Loan Credit Score (and trends)
  3. Loan Loss Expense trends
- When is a Loan Good?
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Delinquent Loans to Total Loans:

Del Loans/Loans

Dec-01 Dec-02 Dec-03 Dec-04 Dec-05 Dec-06 Dec-07

ALM Policy Limits

Dec-01 Dec-02 Dec-03 Dec-04 Dec-05 Dec-06 Dec-07

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Measuring Liquidity Risk

- Maturity Gap
- Cash Flow report
- Source and uses of Funds reports
- CAMELS Ratios
  - Trends of Loans to Deposits
  - Long Term Assets to Total Assets
  - Percentage of Funds from outside sources
- Important point about liquidity risk: Purpose is to look at trends of your liquidity, and make sure funding is there for loans and potential withdrawals of deposits
  - FHLB Advances
  - CD “specials” – are they worth it?
  - Loan promotions
  - Your investment portfolio maturity schedule

Sample Institution - Assets

Total Assets

Balance Sheet - Month-End Balance

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth %</th>
</tr>
</thead>
<tbody>
<tr>
<td>05</td>
<td>7.6%</td>
</tr>
<tr>
<td>06</td>
<td>7.7%</td>
</tr>
<tr>
<td>07</td>
<td>8.0%</td>
</tr>
<tr>
<td>08</td>
<td>12.8%</td>
</tr>
<tr>
<td>09</td>
<td>2.8%</td>
</tr>
<tr>
<td>10</td>
<td>6.2%</td>
</tr>
<tr>
<td>11</td>
<td>7.9%</td>
</tr>
<tr>
<td>12</td>
<td>2.6%</td>
</tr>
<tr>
<td>13</td>
<td>7.8%</td>
</tr>
<tr>
<td>14</td>
<td>2.6%</td>
</tr>
<tr>
<td>15</td>
<td>3.9%</td>
</tr>
<tr>
<td>16</td>
<td>6.0%</td>
</tr>
<tr>
<td>17</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

- History
- Projection
- Maturity Remaining Balance
Sample Institution – Liabilities and Equity

Maturity Gap for Liquidity Risk

- Amount, then computed Ratio of assets maturing versus liabilities maturing. Note when an asset or liability matures may NOT be the same as it reprices.
- If the curves of maturity are the same, the ratio would be 100%
- It is OK to be mismatched in maturity - just make sure they are reasonable:
  - Typical ALM Policy limits are between 50% and 300%. Outside is the Red Zone.
  - The higher the number, the more assets you have maturing
  - The lower the ratio the more liabilities you have maturing

Maturity Gap for Liquidity Risk
ALM Policy Limits:

- The ALM policy, along with policy limits, needs to be reviewed formally once a year.
- Remember, these are the Red Zone limits.
- Debate – should I use a "shock" or "ramp" in the ALM policy?
- What should I show the ALCO? The Board? The Examiners?
- Note that long-term financial targets are there for a reference.

ALM Policy Limits – alternative approaches:

Two alternatives to ALM policy limits and how the ALCO and Board looks at ALM:

1. Floor and Ceiling Values (Line in the Sand)
2. Sensitivity Ranges (rate or slope of change)

- Both can use Red Zone concept.
- Sensitivity ranges use to be preferred by examiners, but that is changing.
- Be careful...Sensitivity ranges can make the results look worse than it really is.
- ....so, many institutions use the Floor and Ceiling Values (Line in the Sand approach).
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Alternative 1: ALM Policy Limits using Floors and Ceilings

- Express them in ranges or floors and ceilings!
  - If you set the policy to a single number what may happen?
  - They will change from time to time
- Think of ALM policy limits as absolute *lines in the sand*
  - You don’t want to go beyond them
  - This is the Red Zone. You also may have a "yellow zone", but NOT in the ALM policy.
  - Be careful of your reporting style
- Policy Limits can be more liberal if:
  - You are financially strong
  - You know what you are doing

Earnings at Risk “Shock” Alternative 1 - using a Floor

Note: This is a full “Rate Shock” scenario. Rate Ramps usually show less risk.
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IRR on Earnings –
Absolute Limits Approach using a Floor:

<table>
<thead>
<tr>
<th>Interest Rate &quot;Shock&quot; on ROA</th>
<th>Current ROA 9/07</th>
<th>Projected ROA 12/08</th>
<th>ALM Policy Limits &quot;Red Zone&quot;</th>
<th>&quot;Yellow Zone&quot; (not in the policy)</th>
</tr>
</thead>
<tbody>
<tr>
<td>+300 Basis Points</td>
<td>.83</td>
<td>&gt; .25</td>
<td>&gt; .5</td>
<td></td>
</tr>
<tr>
<td>Flat</td>
<td>1.35</td>
<td>1.24</td>
<td>&gt; .25</td>
<td>&gt; .5</td>
</tr>
<tr>
<td>-300 Basis Points</td>
<td>1.50</td>
<td>&gt; .25</td>
<td>&gt; .5</td>
<td></td>
</tr>
</tbody>
</table>

Alternative 2: ALM Policy Limits using Sensitivity Approach

- Sensitivity approach measures the variance from a base set of numbers
- How wild of swings are there?
- Think of ALM policy limits as a percentage change
  - You don’t want to go beyond them
  - This is the Red Zone. You also may have a "yellow zone", but NOT in the ALM policy.
  - Be careful of your reporting style
- Be careful – using sensitivity approach may show you worse results than what really exist
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Earnings at Risk “Shock” now with the Sensitivity Approach – Case A

Note: This is a full "Rate Shock" scenario. Rate Ramps usually show less risk

Sensitivity Ranges Approach Case A:

<table>
<thead>
<tr>
<th>Interest Rate &quot;Shock&quot; on ROA</th>
<th>Current ROA 9/07</th>
<th>Projected ROA 12/08</th>
<th>% Change</th>
<th>% Change Policy Limit Red Zone</th>
</tr>
</thead>
<tbody>
<tr>
<td>+300 Basis Points</td>
<td>1.35</td>
<td>1.27</td>
<td>-5.9%</td>
<td>&gt; +30%</td>
</tr>
<tr>
<td>Flat</td>
<td>1.50</td>
<td>1.50</td>
<td>+11.1%</td>
<td>&gt; +30%</td>
</tr>
</tbody>
</table>

Are we outside our ALM policy limits?
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**Sensitivity Ranges Approach Case B:**

<table>
<thead>
<tr>
<th>Interest Rate &quot;Shock&quot; on ROA</th>
<th>Current ROA 9/07</th>
<th>Projected ROA 12/08</th>
<th>% Change</th>
<th>% Change Policy Limit Red Zone</th>
</tr>
</thead>
<tbody>
<tr>
<td>+300 Basis Points</td>
<td>.75</td>
<td>.68</td>
<td>-8.4%</td>
<td>&gt;-30%</td>
</tr>
<tr>
<td>Flat</td>
<td>.75</td>
<td>.80</td>
<td>+6.3%</td>
<td>&gt;-30%</td>
</tr>
<tr>
<td>-300 Basis Points</td>
<td>.83</td>
<td>.83</td>
<td>+10.5%</td>
<td>&gt;-30%</td>
</tr>
</tbody>
</table>

**Earnings at Risk “Shock” now with the Sensitivity Approach – Case A**

![Graph showing earnings at risk changes over time](image)

**Note:** This is a full “Rate Shock” scenario. Rate Ramps usually show less risk.
**Case B:**

Projected ROA if rates FALL -300 BP

Projected ROA if rates RISE +300 BP

**Net Economic Value: Absolute Limits Approach**

EVE to Assets vs. Book Capital to Assets
Net Economic Value: Sensitivity Approach

EVE to Assets vs. Book Capital to Assets

A

B

Absolute Limits Approach versus Sensitivity Approach: Case A and B compared

<table>
<thead>
<tr>
<th>Interest Rate “Shock” on ROA</th>
<th>Maximum Percentage Change in ALM Policy (RED ZONE)</th>
<th>Current NEV to Assets</th>
<th>% change from the Flat Rate Scenario</th>
<th>Current NEV to Assets</th>
<th>% change from the Flat Rate Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>+300 Basis Points</td>
<td>+ - 30%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flat Rate Scenario</td>
<td>N/A</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-300 Basis Points</td>
<td>+ - 30%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Book Value Capital to Assets (for comparison)</td>
<td>13.5%</td>
<td>N/A</td>
<td>8.75%</td>
<td>N/A</td>
<td></td>
</tr>
</tbody>
</table>

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Absolute Limits Approach versus Sensitivity Approach:
Case A and B compared

<table>
<thead>
<tr>
<th>Interest Rate “Shock” on ROA</th>
<th>Maximum Percentage Change in ALM Policy (RED ZONE)</th>
<th>Case A</th>
<th>Case B</th>
</tr>
</thead>
<tbody>
<tr>
<td>+300 Basis Points</td>
<td>+ - 30%</td>
<td>10.1%</td>
<td>-40.6%</td>
</tr>
<tr>
<td>Flat Rate Scenario</td>
<td>N/A</td>
<td>14.2%</td>
<td>N/A</td>
</tr>
<tr>
<td>-300 Basis Points</td>
<td>+ -30%</td>
<td>19.3%</td>
<td>+35.9%</td>
</tr>
<tr>
<td>Book Value Capital to Assets (for comparison)</td>
<td>13.5%</td>
<td>N/A</td>
<td>8.75%</td>
</tr>
</tbody>
</table>

ALCO/Board of Directors reporting on ALM

- KISS!
- Needs to Address Financial position AND Main Risks:
  - Financial Position with Trends (Balance Sheets, Income Statements, CAMEL Ratios)
  - Credit Risk
  - Liquidity Risk
  - IRR on Earnings
  - IRR on Capital
- ALCO usually meets once a month or quarter, Board gets a summary once a quarter
- Remember your audience!
ALM Strategies

- ALM Strategies help the customers or the membership!
- Important you are looking at proper techniques and their results before making a conclusion.
- An ALM strategy is used to maintain or change an ALM position. The ALCO needs to decide which one.
- Track your strategies and see a before and after effect. Test how good your projections are as well.
- Do you know how to interpret a good or bad situation? (Hint... Look at the RED ZONE!)

Conclusions on ALM policy, measures and policy limits:

- Start with the philosophy and business strategy of your institution
  - Determine your "risk profile"
  - Understand the Red Zones are the policy limits
- Craft a good ALM policy, with policy limits
- Make sure you are measuring the proper items for the ALCO, Board, and Examiners
  - Pick your measures (CAMELS ratios, Income Simulation, etc.)
  - Pick your approach (Line in the sand or Sensitivity Ranges)
  - Put the Red Zone on your reports!
- Take Action!
- Questions?
Questions?

- Select *1 now to ask a live question through the phone
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Developing a Realistic ALM Policy
And Policy Limits
Feb 26, 2008

“Developing a Realistic ALM Policy and Policy Limits”

Tuesday Feb. 26, 2008

FMS Webinar Series

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