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A/LM Modeling Questions Commonly Asked by Examiners…

…when assessing your understanding of your credit union's A/LM modeling process

Below are summary answers to questions regarding how key assumptions you've made about your credit union and how embedded options are handled in c. myers' Interactive Decision Model. We use the Interactive Decision Model to quantify long-term risks to earnings and net worth for you and all of our other clients. Additionally, many clients have discovered the convenience of using the model at their credit union.

Are loans and investments categorized appropriately to capture unique risk characteristics?

Yes. The chart of accounts is customized for each credit union, taking into account unique risk attributes such as maturity, prepayment sensitivity and repricing index, frequency, caps or spreads.

Is the impact of embedded options factored into the simulation?

Yes. Embedded options associated with loans, investments, members' CDs and borrowings are modeled to capture caps, floors, calls, puts, lags, etc. For example, each callable investment and CMO is simulated individually, taking into account their unique call or cash flow characteristics.

Do loan prepayments change in different rate environments?

Yes. Prepayment speeds are customized for each loan category. These prepayments automatically adjust as interest rates move to represent changes in member behavior in different rate environments. For example, mortgage prepayments increase in a falling rate environment and slow down in a rising rate environment. Mortgage prepayments are based on the Office of Thrift Supervision assumptions and, if appropriate, adjusted based on membership base and/or geographical location.

Does your credit union's deposit pricing and members' rate sensitivity change under different rate environments?

Yes. Pricing assumptions are developed for each deposit category to represent the credit union's pricing strategy in changing market interest rate conditions. Levels of rate sensitivity are established for each deposit category, reflecting the credit union's best understanding of their membership. Additionally, the model takes into account that some members may move their money because they may be dissatisfied with current rates being offered. That sensitivity varies by balance tiers as well as degree of advantage for members to move their money. Therefore, within each deposit category, different levels of member behavior are represented and automatically adjusted as market interest rates change.

Have you tested the impact to your credit union's financial structure if your assumptions on deposit rate sensitivity and loan prepayments are wrong?

Yes, many of our clients can answer. If you have not asked the question, "What if my assumptions are wrong?" please call us.

Additional points well worth remembering.

To provide you with an **Early Warning System** of risks to earnings and net worth our model uses a backdrop of 64 history-based rate environments and changing yield curves. These rate environments include, and go well beyond, a 300 basis point parallel shift in rates.

Remember, to use A/LM as a weapon you can't stop at quantifying risks. It is also important to:

- Agree on your appetite for risk by establishing risk limits
- Test financial consequences of major decisions before implementing
- Take action to manage risk – the sooner you address a problem the more options you will have for solving it
- Effectively communicate overall risk and return to decision makers

We welcome your questions and comments
You can contact me by telephone at 800.238.7475, or by email at rjohnson@cmyers.com.

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