Deposit Guarantee Corporation of Manitoba
La Société d’assurance-dépôts du Manitoba

Guideline

Subject: Asset Liability Management (ALM)

Effective Date: July 1, 2022

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1.0 Overview

On July 1, 2022, DGCM issued new Standards of Sound Business Practice (SSBP) pursuant to s. 159.1 of *The Credit Unions and Caisses Populaires Act*. All credit unions and caisse (cu/caisse) must comply with SSBP that apply to them (s. 159.1).

The SSBP are available at this link:

https://web2.gov.mb.ca/laws/regs/annual/2022/089.pdf

The SSBP contain rules respecting cu/caisse capital, liquidity, investments, lending, and other matters. The SSBP also contain a set of principles that assist cu/caisse to direct and manage their institution in a prudent, effective, and appropriate manner. These are further defined in DGCM's **SSBP Guidance Framework**.

The Asset Liability Management (ALM) Guidelines better define DGCM's expectations on how a cu/caisse can comply with the SSBP with respect to Standard # 3 – Risk Management. The goal is to better define DGCM's expectations on how a cu/caisse can comply with the SSBP with respect to ALM.

These guidelines draw upon standards published by other regulators in Canada and are not intended to be exhaustive.

Application to CUCM
DGCM is the prudential oversight body for Credit Union Central of Manitoba (CUCM). DGCM has issued Prudential Standards applicable to CUCM. These Guidelines also better define DGCM's expectations on how CUCM can comply with the Prudential Standards with respect to ALM.

2.0 Asset Liability Management

ALM is the active and prudent management of the balance sheet. ALM involves managing liquidity, structuring maturity commitments, and managing the capital base to generate satisfactory levels of financial margin with acceptable levels of risk.

ALM is often discussed in the specific context of managing interest rate risk. When providing guidance on ALM, some Canadian regulators of deposit-taking institutions use a more expansive definition of ALM to include other risk management practices. These Guidelines follow that approach and include guidance on management of interest rate risk, liquidity, capital, and investments.

Interest Rate Risk Management
Interest rate risk is the cu/caisse's vulnerability to movements in interest rates. Basic interest rate risk management can minimize negative swings in net income. More advanced interest rate risk management allows the board and management to strategically position the cu/caisse to take advantage of potential gains arising from changes in interest rates and member behaviour.

Liquidity Risk Management
Liquidity risk is the potential failure to meet anticipated day-to-day cash commitments or maintain minimum levels of statutory liquidity and comply with DGCM's Intervention Policy targets. Managing this risk involves understanding a cu/caisse's funding sources, liquidity needs, and business opportunities. Liquidity risk management is also about managing growth.

Capital Risk Management
Capital risk is the potential failure to maintain sufficient quantity and quality of capital and plan for future capital requirements. Managing capital risk includes implementing pricing and cost control practices, ensuring sustainable growth, and establishing/meeting capital targets in excess of legislative minimum requirements and the Intervention Policy buffer.

Investment Risk Management
In the Manitoba context, a cu/caisse's investment strategy involves risk management of its excess liquidity within the prescribed investment rules. This includes investments in land, buildings, eligible corporations, or other investments permitted under Credit Union Central of Manitoba's Charter By-Laws.

A cu/caisse must set its risk tolerance and its investment objectives. It must understand the regulatory rules on investments and the impact investment decisions can have on its profitability, liquidity, and capital position.

3.0 Governance Standards

3.1 Board Policies and Planning

The cu/caisse's board, with support and advice from management, is responsible for approving ALM policies, targets, and risk tolerances. The board is also responsible for overseeing management compliance with the policies and targets. To do so, the board must follow an appropriate governance framework.

These concepts are set out in Standard # 3 – Risk Management. The **SSBP Governance Framework** lists the following board responsibilities:

- Review and approve appropriate and prudent asset/liability, liquidity, and capital management policies;
- Understand the cu/caisse's statutory and operational liquidity and capital needs;
- Establish capital management targets that are appropriate based on the size and complexity of the cu/caisse. This includes setting targets in excess of legislative minimum requirements.

The cu/caisse should incorporate ALM into its annual planning cycle. For example, at its annual planning session, a board can review its existing ALM policies or targets and discuss whether these should be modified.

The board or a committee of the board that is assigned responsibility for policy development/review should ensure that ALM policies are reviewed on a regular basis. Policies should deal, in a comprehensive manner, with all ALM risks identified in these Guidelines.

3.2 Board Reporting

The Standards provide that the board must receive appropriate reports that will enable them to:

- Monitor the effectiveness of asset/liability management practices;
- Monitor the effectiveness of capital management practices and confirm that regulatory requirements and targets are met;
- Monitor the effectiveness of liquidity management practices with respect to the cu/caisse's liquidity position within established policy and regulatory requirements.

Reports to the board must include sufficient information or supporting material to review the status of ALM targets, policies, and risk tolerances. Supporting material may include financial information, projections, exception reports, or management summary of any reports or analysis generated by use of advanced ALM tools or a third party expert.

The board should review the financial position of the cu/caisse, at minimum, on a quarterly basis. The level of detail and complexity of any board report, analysis, or risk management tools should reflect the size and complexity of the cu/caisse. This is discussed in Section 4.0.

If the cu/caisse is outside of a policy or target, e.g. has a material mismatch, the board report should identify the exception, the impact of the exception on earnings and capital, and a plan of action to correct the issue.

Any financial condition that could lead to staging under the Intervention Policy should also be identified – see Schedule 1 of the Intervention Policy. DGCM recommends that each cu/caisse incorporate Intervention Policy financial indicators (e.g. GOM < 50bps) into their reporting process.

3.3 Board Expertise or Training

A cu/caisse board should collectively have an understanding of ALM risks. The cu/caisse's board and management should consider what level of experience and expertise the board, as a whole, should possess. This will vary depending on the size and complexity of the institution.

The board should ensure that appropriate resources, including ongoing training, are devoted to assist the board in fulfilling its mandate. Training plans for board members should include ALM training if gaps are identified.

4.0 Management Practices

4.1 Standards

Standard # 3 defines the role of the cu/caisse's senior management with respect to ALM. Two key senior management responsibilities listed in the **SSBP Governance Framework** are to:

- Develop, recommend and maintain asset/liability, capital, and liquidity management policies;
- Provide the board with appropriate reports that will enable it to monitor the effectiveness of its policies and practices.

The daily management of ALM risks is the responsibility of management.

As a cu/caisse gets larger and more complex, senior management may assign responsibility for some ALM matters to additional personnel or form a specific management committee often referred to as an Asset Liability Committee (ALCO). The benefit of an ALCO is that different areas of operations can be included in risk management which brings additional expertise and perspective to the table and allows for cross-training.

4.2 Differential Requirements Based on Size and Complexity

Every cu/caisse is expected to comply with the ALM standards set out in the Standards. However, management of ALM risks will vary among institutions depending on its size, complexity, and level of risk.

Recognizing that the members of the cu/caisse Systems vary considerably, these guidelines differentiate between "small" (<$200 million), "medium" ($200 million to $1 billion), and "large" (>$1 billion) institutions based on asset size. Differentiation based on size provides initial parameters; however, DGCM's expectations may vary if a cu/caisse has a complex business model or large branch network.

At all times, appropriate internal resources should be dedicated to ALM. The outsourcing of ALM functions on a targeted basis can bring significant benefits to any cu/caisse, regardless of size, when the expertise is not available in house.

> **Small institutions**: A basic ALM function with one senior manager as the key employee is usually appropriate for small institutions. Institutions that do not have complex business models and have significant capital cushions may

manage their ALM risks using budgeting tools, regular financial and exception reporting, and quarterly static gap analysis.

The use of more advanced tools will better identify risks and business opportunities for improved profit: see Section 4.3.

When a material mismatch (e.g. outside of policy) or risks to capital or earnings (e.g. outside of board risk tolerances) are identified, the cu/caisse must identify a plan of action which includes the use of more advanced ALM tools to measure the impact on profitability and capital.

Medium-sized institutions: This category covers a wide range of institutions, therefore DGCM's expectations for ALM will vary depending on the size, complexity, and level of risk.

In addition to the requirements for small institutions, DGCM expects that all medium-sized institutions will regularly employ, at minimum, dynamic gap analysis. Those at the higher end of the asset size spectrum should consider regular use of more advanced ALM tools to quantify impact on profitability and capital.

Regardless of size, when a material mismatch or risks to capital or earnings are identified, the cu/caisse must identify a plan of action which includes the use of more advanced ALM tools to measure the impact on profitability and capital.

As medium institutions grow in size or complexity, it should assign ALM responsibility to additional senior personnel or establish a formal ALCO.

Large institutions: In addition to the requirements for medium institutions, DGCM expects that large institutions will employ more robust ALM tools such as simulation analysis or other stress testing, including stress testing for liquidity risk.

For institutions that have material concentrations of non-traditional liquidity sources (e.g. virtual, broker, or mortgage backed securities), stress testing should include testing those sources.

Large institutions should have sufficient internal staff/resources with expertise in ALM. Large institutions should establish a management ALCO.

4.3 Risk Management Tools

Regulatory Requirements

The Credit Unions and Caisse Populaires Act and *Regulations* provides that a cu/caisse must maintain minimum statutory capital and liquidity and limit its investments to those items listed in Credit Union Central of Manitoba's Charter By-laws. The Act and Regulations also require each cu/caisse to prepare a quarterly static gap matching report. This will continue to be a basic requirement.

Static gap analysis is a simple interest rate risk measurement tool that reports the match position between interest rate sensitive assets and liabilities in maturing or re-pricing time buckets. This methodology is focused on a point in time.

Various weaknesses exist with static gap analysis. It does not consider member activity such as changes in deposits, redemptions, or loan activity. It assumes that assets and liabilities will react in exactly the same way to a change in interest rates.

A board that is setting its interest rate risk policy based solely on static gap metrics may not get a full understanding of risks facing the cu/caisse or opportunities available to it. Use of advanced tools can lead to more relevant board policies, targets, or risk tolerance.

Advanced Tools

There are a number of tools that can assist a cu/caisse in identifying ALM risk and measuring impacts on interest rate risk, profitability, capital, and liquidity. The usefulness of each measurement tool will depend on the validity of the assumptions which should be reviewed on a regular basis.

The following definitions are basic descriptions of some ALM tools. The list of ALM tools is not intended to be exhaustive.

Dynamic Gap Analysis
Dynamic gap analysis expands upon static gap by adding assumptions about member behaviour on various products including loan prepayments, new business cash flows, and other assumptions.

Earnings or Equity at Risk
Interest rate risk may also be measured as it relates to earnings (earnings at risk EaR) and capital (economic value of equity at risk, EVaR). EaR is a model based analysis that measures the impact that changes in interest rates have on a financial margin. The

EVaR test measures the impact of changes in interest rates on the capital of the cu/caisse by calculating the present value of all future cash flows.

Duration Analysis
Duration analysis is a modified gap analysis that calculates the present value of future cash flows and expresses it as a single number. This number is expressed in time periods such as days, months, or years. Once the duration has been calculated, this calculation can be expanded to measure the impact of interest rate changes on EVaR.

Simulation Analysis and Other Stress Testing
Simulation analysis is a more complex tool which tests the impact of various scenarios on the net income and balance sheet of the cu/caisse and covers all ALM risks. Changes to interest rates, product growth rates, member behavior, pricing, new products, and other income and operating expenses can be introduced. It can be used to test the impact of reasonably probable scenarios and high stress scenarios.

The Office of the Superintendent of Financial Institutions (OSFI) expects deposit taking institutions to perform a wider range of stress testing:

> Stress testing programs should apply across business and product lines and cover a range of scenarios, including non-historical scenarios.

Liquidity Testing
A cu/caisse may use simulation analysis and other stress testing to identify liquidity risks. These risks will depend on the cu/caisse's liquidity status, business model, or risk tolerance. One stress scenario is to examine deposit concentration and identify future liquidity constraints. Other scenarios can be tailored for any cu/caisse with material concentrations in virtual or broker deposits or mortgage backed securities.