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Striking a Balance

Getting the most – not just the required – out of ALM and liquidity risk management

Despite a steady drumbeat of negative news, **Bart Smith** actually thinks community institutions are in a pretty good position right now to take advantage of more promising economic and interest rate conditions on the horizon. However, the managing director at Performance Trust Capital Partners in Chicago, Ill. believes regulatory concerns may be holding many institutions back from achieving their full potential.

"The biggest issue for bankers right now is managing regulatory expectations in a way that allows them to sustain economic vitality for their organizations," he says. "The fear of potential regulatory displeasure is almost as big of an impediment to an institution's financial performance as are the actual regulations themselves."

So how can institutions get over this hump? How can they focus on both meeting regulatory expectations and generating stronger earnings? Smith says that one great opportunity is to look beyond simple appeasement when managing their ALM and liquidity risk, with an eye on actually boosting performance. He shares his thoughts on this and several other topics in this edited interview with the *Update*.

FMU: What are some of the major ALM changes – in terms of focus or practice – that you've observed in community institutions in recent years?

Smith: Since interest rates have fallen to, and lingered at, historic lows, ALM attention in recent years has become hyper-focused on the risk of rates rising. You see this most notably in the attention being paid to non-maturity deposit behavior and the extension risk associated with longer-term assets. While these factors are certainly important to consider, I think it's also important to think about the risks to institutions should rates stay at or near their current levels for a prolonged period of time. In considering either risk, it's important to have the right assumptions in place to make accurate and informed decisions across the entire balance sheet. Overly conservative assumptions created solely to satisfy perceived regulatory expectations or overemphasize the particular risk of an unprecedented rate spike tend to impede sound decision-making in this area.

FMU: What are some of the more blatant disconnects between regulatory guidance and common practice in terms of interest rate risk? What can institutions do to help close these gaps?

Smith: Regulatory guidance around interest rate risk has been evolving for decades, with the most comprehensive guidance so far issued over just the past five years. The biggest disconnect between regulatory guidance and common practice is that regulatory guidance is geared toward risk prevention, while asset-liability management, at its core, should be a performance management and improvement function.

Perhaps the biggest example of this disconnect can be seen in the regulatory approach to economic value of equity. Regulatory guidance requires that banks adopt a model that shocks interest rates instantaneously. In practice, however, we know that rate changes tend to occur over some period of time. If an institution only measures its position against an instantaneous rate shock without also considering more realistic scenarios that play out over time, it will not have the information it needs to make informed and accurate strategic business decisions that enhance profitability while controlling risk.

The ALM modeling process is full of assumptions that can either be overly aggressive or overly conservative. My biggest recommendation to clients is that they fully understand the major assumptions that drive the reported outcome of their models, and that they also explore scenarios that

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provide more than just a compliance-level overview of their positions. It's important to remember that asset-liability management is really about measuring the trade-offs between current and future income. As it stands today, the industry methodology of income simulation and economic value do not measure those trade-offs effectively. Income simulation alone doesn't count all the longer-term cash flows, primarily serving as a measurement of the reward component. Economic value analysis, while considering all the cash flows, is based on present values and not scenario-based future values, focusing more exclusively on risk.

It is very difficult to measure and consider these approaches independently, which is why so many institutions do not use interest rate risk reports for ongoing strategic decisions. As a means to better measure the strategic risk/reward trade off, institutions may want to consider developing reporting and modeling techniques that go beyond the basic report sets required by the regulators. Models that include both earnings and economic scenarios in combination, over reasonably projected time horizons and rate scenarios, can be particularly effective for this type of broader analysis.

The ALM modeling process should be thorough and sophisticated enough to usefully discriminate between the impacts of different strategies and decisions over various time periods and scenarios. If applied properly, the ALM process can have enormous utility for improving near- and long-term structural positions, allowing an institution to improve earnings and maximize value within appropriate risk parameters.

Asset-liability management should not be viewed as a compliance exercise. It is much more valuable than that, or at least it should be.

Bart Smith
Managing Director, Performance Trust Capital Partners
Chicago, Ill.

FMU: How about liquidity risk? What are institutions missing there?

Smith: In my view, from a tangible impact perspective, liquidity risk is much more critical than interest rate risk. In my 25 years as a regulator – including time in some of the hardest hit economies in the country – I never once saw an institution fail because of interest rate risk. However, I have seen many failures, among them some of the largest banks in the country, due to liquidity risk.

Currently, most community institutions evaluate liquidity risk through a set of static ratios, the most common of which is a liquidity ratio that measures cash and net marketable assets against total liabilities. Other common ratios attempt to reveal volatility exposures in the institution's deposit base. These ratios are required by the regulators, but they do little to resolve ongoing issues related to active liquidity risk management.

From my perspective, liquidity analysis is best performed through an understanding and active management of the institution's expected cash flow position under a variety of realistic stress scenarios. Conducting this type of analysis helps to identify weaknesses in funding position, but it also helps to illustrate the stability of certain deposits, which tend to get discounted under certain static measurement techniques. The 2010 Interagency Guidelines on Funding and Liquidity Risk Management already require this type of forward cash flow analysis, so my advice is to get your own procedures in place before more onerous and less meaningful regulatory procedures are imposed.

FMU: Based on what you've seen and what you know regulators are looking for, if an institution was to focus on improving just one aspect of its ALM/liquidity practices, which would you recommend?

Smith: Asset-liability management should not be viewed as a compliance exercise. It is much more valuable than that, or at least it should be. In my view, ALM should be about crafting a quantified balance sheet strategy that improves earnings and optimizes shareholder value under appropriate risk constraints. If you fully understand your assumptions and build a modeling process that goes beyond basic expectations, you will be in a much more powerful position to support your strategy in the face of regulatory inquiry, and in turn be given the space to help your organization perform today and in years to come. FMU