

Asset Liability Management: The Fundamentals

By Toby Lawrence, Principal
Financial Institution Advisory Services



Disclaimers

To ensure compliance imposed by IRS Circular 230, any U. S. federal tax advice contained in this presentation is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed by governmental tax authorities.

The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice or opinion provided by CliftonLarsonAllen LLP to the user. The user also is cautioned that this material may not be applicable to, or suitable for, the user's specific circumstances or needs, and may require consideration of non-tax and other tax factors if any action is to be contemplated. The user should contact his or her CliftonLarsonAllen LLP or other tax professional prior to taking any action based upon this information. CliftonLarsonAllen LLP assumes no obligation to inform the user of any changes in tax laws or other factors that could affect the information contained herein.

Housekeeping

- If you are experiencing technical difficulties, please dial: **800-422-3623.**
- **Q&A session will be held at the end of the presentation.**
 - Your questions can be submitted via the **Questions Function at any time during the presentation.**
- The PowerPoint presentation, as well as the webinar recording, will be sent to you within the next **10 business days.**
- Please complete our online survey.

About CliftonLarsonAllen

- A professional services firm with three distinct business lines
 - Accounting and Consulting
 - Outsourcing
 - Wealth Advisory
- Serve 1,100+ financial institutions
- 3,600 employees
 - 200 professionals
 - More than 25 principals
- Offices coast to coast



Speaker Introduction

Toby Lawrence, CPA, Consulting Principal

Toby has 27 years of experience including 2+ years as a bank president and CEO. He has served literally hundreds of financial institutions in his career ranging in size from \$50 million to well over \$16 billion in total assets. Toby has served as a consultant to the Federal Deposit Insurance Corporation and the Federal Housing Finance Agency that oversees Freddie Mac, Fannie Mae, and the Federal Home Loan Bank system. He has also served hundreds of banks and credit unions across the country and internationally.

Toby's consulting experience includes providing loan review services, regulatory compliance services, asset liability model reviews, internal audit program development and outsourcing, merger and acquisition services, profit improvement and operational reviews, strategic planning, litigation support services, temporary CEO services, FATCA compliance and implementation, and preparation of regulatory applications including in the formation of de novo banks.



Learning Objectives

- Understand why asset liability management (ALM) is on the radar of regulators and what you need to do to prepare for your next safety and soundness exam.
- Know what should be included in your ALM policy and the type of analysis and documentation to include in your asset liability committee meetings (ALCO).
- Recognize the latest trends and best practices in ALM.

Why is ALM on the Radar of Regulators?

- Results of Material Loss Reviews performed by the FDIC, OCC, and the NCUA included among other findings that failed institutions generally:
 - Relied heavily on alternative sources of funds (internet CDs, brokered deposits, FHLB advances) to fund loan growth which reduced the institution's net interest margin and net earnings.
 - Certain institutions experienced significant liquidity shortages that directly led to the failure of the institution.
 - Experienced declining net interest margins that in turn, caused the institutions to chase yields and originate higher risk loans including loans they didn't have any experience with (i.e. land development loans).

Why is ALM on the Radar of Regulators?

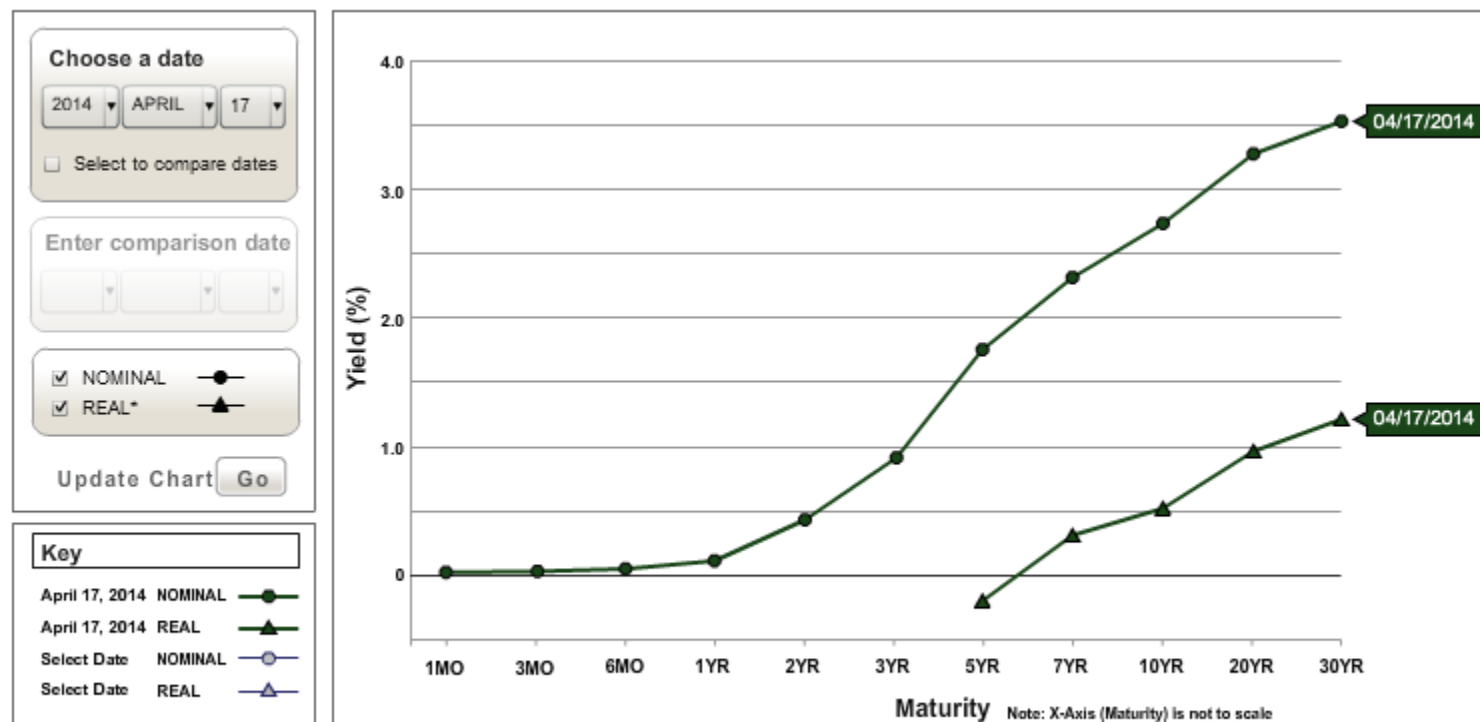
- Results of Material Loss Reviews performed by the FDIC, OCC, and the NCUA included among other findings that failed institutions generally:
 - Board of Director members and many members of the ALCO committee didn't fully understand ALM concepts and / or the ALCO didn't have the information it needed to properly evaluate the institution's liquidity and interest rate risks.
- The savings and loan crisis of the late 80's and early 90's was also a direct result of inadequate ALM.

Why is ALM on the Radar of Regulators?

- The yield curve on U.S. Treasury bonds show a significant increase in long-term interest rates.
- Loan demand in many markets has been weak leading to certain institutions weakening their underwriting standards.
 - The maturities of loans are being extended beyond the economic life of the collateral or beyond the expiration date of leases for rental properties.
- Significant mismatch between the terms customers want for loans and term deposits.

Why is ALM on the Radar of Regulators?

Treasury Yield Curve



[View Text Version of Treasury Yield Curve](#)

* Data for real maturities may not be available for all dates for which nominal maturity data is available.

Why is ALM on the Radar of Regulators?

- Sheila Baird, former Chairperson of the Federal Deposit Insurance Corporation, has stated in various speeches that asset liability management is the single greatest risk in the banking industry today.

What Do Regulators Expect of You?

An institution should have:

- Adequate written ALM policies and procedures.
 - Does ALCO have the information it needs to properly manage interest rate and liquidity risk?
 - Does ALCO place too much reliance on consultants or its ALM software provider?
- Utilized reasonable assumptions in its ALM software model that are supportable with historic data.
- Its ALM software model validated by a reputable third party on an annual basis.
- Provide periodic training to the Board of Directors and ALCO committee.

What Do Regulators Expect of You?

- Minutes of the ALCO committee should list the strategies used by ALCO to price the institution's products and services and manage ALM.
 - The ALCO minutes should be included in the Board of Director packets and the Board should include a statement in its minutes that it has reviewed these ALCO minutes and approves the actions and decisions made by ALCO.
- The minutes should also clearly demonstrate that the ALM committee had sufficient information to perform its assigned duties.

What Do Regulators Expect of You?

- The ALCO minutes should include:
 - Economic data from 2 to 3 reliable reputable sources.
 - ◇ Correspondent bankers or investment advisors often provide this information for free.
 - ◇ Freddie Mac and Fannie Mae publish economic data on their web sites.
 - ◇ Local realtor associations and the local Chamber of Commerce.
 - Comparative pricing information on the institution's products and services (i.e. RateWatch).

What Do Regulators Expect of You?

- The ALCO minutes should include:
 - Discussion of the institution's pricing and ALM strategies including justification as to why strategies were used or not used. Examples include:
 - ◇ Description of your pricing philosophy (where you want to be in the market and why).
 - ◇ The rationale behind the establishment of maturity targets or average weighted maturities for loans, deposits, and investment securities.
 - ◇ The plan and rationale for any marketing efforts or changes in the pricing of any of the institution's products or services.
 - ◇ What ALCO intends to do to address any significant deficiencies in the institution's GAP position. ALCO should be addressing the institution's GAP position both over the short term (i.e. 90 days, 180 days, and one year) and long term (i.e. 2 years, 3 to 5 years, 5 years, 6 to 8 years, 8 to 10 years, and over 10 years).

What Do Regulators Expect of You?

- The ALCO minutes should include:
 - GAP analysis showing sufficient detail on scheduled maturities.
 - ◇ Identify repricing mismatches.
 - ◇ Too many institutions focus only on the short term GAP positions (maturities of 1 to 2 years) when the greater risk currently is in the longer term net Gap positions (maturities of 5 to 10 years).
 - ◇ Consider utilizing both static and variable simulations to evaluate interest rate and liquidity risk.
 - In a static analysis, the balances of interest bearing assets and liabilities don't change while in a variable analysis the balances change both because of scheduled maturities and changes in demand at various interest rate levels.

What Do Regulators Expect of You?

- The ALCO minutes should include:
 - Software model simulations should be run at least on a quarterly basis to evaluate changes in the net interest margin and economic value of equity (EVE) at interest rate changes of plus or minus 100, 200, 300, and 400 basis points.
 - ◇ Consider using both a 12 month and 24 month time horizon for this analysis.
 - Cash flow projections for the next 30, 90, and 180 days on a monthly basis.
 - Sensitivity analysis to test the adequacy of your contingency plan on at least a quarterly basis.
 - Documentation that your ALM model was validated on at least an annual basis.

Content of the ALM Policy?

- Purpose and scope of the ALM policy including a discussion of the various risks that a financial institution faces.
- Listing of the ALCO committee members and responsibilities assigned to the committee.
 - ALCO should include members from all the key functions or departments within the institution and senior management.
- Required frequency of the ALCO committee meetings and the standard agenda and type of information to be reviewed in the meetings.

What Should be Included in Your ALM Policy?

- ALM policy guidelines. Typical ratios include acceptable ranges or minimums for:
 - Capital
 - Earnings (net interest margin, efficiency ratio, return on assets, and return on equity).
 - Liquidity (loan to deposit ratio, non-core funds dependence ratio, and percentage of contingent alternative funds available to total deposits outstanding)
 - Interest Rate Risk (Cumulative repricing GAP ratios at various time intervals).

What Should be Included in Your ALM Policy?

- ALM policy guidelines. Typical ratios include acceptable ranges or minimums for:
 - Acceptable detrimental impact of interest rate shocks of + or - 100, 200, 300, and 400 basis points on the institution's net interest margin and economic value of equity.
 - Discussion of what must be done and by what time frame if the institution falls outside these policy guidelines.
- Contingency plan that includes an identification of the red flags that may indicate the institution could have a liquidity shortage in the future along with a plan to address the issue.
 - Use different levels of severity that are triggered by both objective and subjective measurements.
 - Discuss how the contingency fund is to be tested and the required frequency of such testing.

What Should be Included in Your ALM Policy?

- Requirement that the ALM model is to be validated annually.
- Examples of the reports to be used by ALCO.

Approach to Validating ALM Models

- Typical procedures include:
 - Determine whether the institution has established an ALCO committee and that all significant functions or departments within the institution are represented on the committee.
 - Evaluate the adequacy of the information provided to the ALCO committee and the minutes maintained by the committee.
 - Evaluate the level of the Board of Directors' involvement in and oversight applied to the ALCO function.
 - Obtain a copy of the institution's ALM policy and evaluate the adequacy of the policy in comparison to both current regulatory requirements and industry best practices.
 - Obtain a copy of the liquidity contingency plan and determine if the plan appears adequate to address any sudden significant losses of the institution's funding sources.

Approach to Validating ALM Models

- Typical procedures include:
 - Obtain the institution's asset liability software reports as of the review date and gain an understanding of the major assumptions used in the calculation of the institution's net interest margin and economic value of equity at + or – 100%, 200%, 300%, and 400% interest rate fluctuations.
 - Evaluate the reasonableness of the projected interest rates and balances of interest bearing assets and liabilities used in these calculations.
 - Agreed historical data used in the model to the institution's balance sheet and other financial records on a sample basis.
 - Recalculate the mathematical accuracy of the calculations used in the model on a sample basis.

Approach to Validating ALM Models

- Typical procedures include:
 - Segregate the projected maturities of earning assets and liabilities in the model into scheduled maturities (the asset or liability is contractually scheduled to mature) and those maturities that are expected to occur because of interest rate fluctuations.
 - ◇ Agree the scheduled maturities to the institutions historical records.
 - ◇ Evaluate the reasonableness of the projected net changes in interest bearing assets and liabilities due to interest rate fluctuations on a sample basis.
 - Perform look back testing.

Best Practices and Trends

- Loan demand has been soft in many markets leading financial institutions to soften their underwriting standards.
 - Loan terms that extend beyond lease terms or economical useful life of the collateral.
 - Examiners are monitoring this situation closely.
- Greater reliance is being placed on alternative funding sources or securities with embedded options.
 - Make sure management understands what it is getting into and how these items re-price.

Best Practices and Trends

- Utilize FHLB advances to fund loans with maturities greater than 3 years.
 - Include penalties in loan agreements that match the prepayment penalties within the FHLB agreement.
- Floors, ceilings, and multiple repricing points are becoming more common.
- Certificate of deposit products allow the customer to bump the interest rate if interest rates go up.

Best Practices and Trends

- Investment securities are being acquired with shorter expected durations sacrificing yield to reduce the institution's interest rate risk.
 - We are seeing weighted average durations of under 3 years.
- More analysis is being performed on security purchases and more extensive documentation is being placed in the file.
- Interest rates on deposits other than certificates of deposit are not price sensitive.
- Utilize a 360 day year on commercial loans.
- The interest rates on certificates of deposit accounts vary by changes in the stock markets.

Available Resources

- If you would like to obtain information on our ALM model validation services, or have interest obtaining a sample ALM policy which includes a contingency funding plan, please send me an email.

Questions?



Thank You

Toby Lawrence, Principal
CliftonLarsonAllen LLP
600 3rd Avenue SE, Suite 300
Cedar Rapids, IA 52401
319-363-2697
toby.lawrence@CLAconnect.com



CLAconnect.com

 [twitter.com/
CLAconnect](https://twitter.com/CLAconnect)

 [facebook.com/
cliftonlarsonallen](https://facebook.com/cliftonlarsonallen)

 [linkedin.com/company/
cliftonlarsonallen](https://linkedin.com/company/cliftonlarsonallen)