



Outsourcing Balance Sheet Risk Management Analyses

A Value-Added Proposition

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With the recent renewed focus by regulators regarding liquidity and interest rate risk, many bankers struggle with the question of whether to perform analyses of their balance sheet risk position in house or to use an outside vendor. Generally, there are three reasons for using an outside resource:

1. The bank does not have the in-house expertise to effectively conduct the analyses;
2. There is a need for a dedicated resource the bank does not possess or cannot afford; and/or,
3. There is a need to have an independent third party that can speak to the issues without being constrained by internal politics.

Any or all of these reasons may serve as justification for a bank to engage an outside resource to assist in the balance sheet management process. Details for these reasons are described below.

- *Many banks do not have the proper skill set* – Most community banks do not have the depth of knowledge required for robust analysis of their interest rate risk or liquidity positions, especially in light of the recent regulatory guidance. This is compounded by the accelerating complexity of the risk measurement process, which can contribute to an incorrect assessment of risk if the data, assumptions and model are not fully understood or mastered. Understanding how to measure and manage balance sheets, these risks require years of hands-on experience that few community bankers possess.
- *Most banks do not have dedicated resources for ALM* – For most community banks, asset/liability management (ALM) is a part, not a full, time job. Accordingly, it is difficult to stay current with best practices in risk management and regulatory compliance requirements. Additionally, analyses/modeling either falls on the plate of the *already stretched, jack of all trades* CFO, or is often delegated to staff that do not possess the set of experiences or *political clout* necessary for creating the degree of ALCO (Asset/Liability Committee) effectiveness required by the current banking environment. As a result, ALM is often a fragmented approach that receives inadequate attention from senior management.

Therefore, the effectiveness in terms of risk identification, strategy formulation, and strategy execution can be very limited or non-existent.

- *Many ALM processes are constrained by internal politics* – Unfortunately, *internal politics* can, and too often does, impede the effectiveness of balance sheet management activities. This is likely to occur in one or more of the following three manners: 1) A/L analysts find it difficult to garner the appropriate level of support/input from the different bank departments that is necessary for developing and maintaining accurate risk management models; 2) in many banks, balance sheet and modeling is viewed as a *Finance* function with lack of meaningful support and/or interest from other departments, including at times the CEO. As a result, the lending and retail areas often view these models (i.e. *their model*) as biased or incomplete when it comes to influencing discussions in their respective

areas, thereby giving them little credence as a management tool for making decisions for such things as loans and deposit pricing and product structure; and 3) old habits and biases die hard, thereby hindering consideration of plausible risk management and earnings enhancing strategies, and/or inhibiting managers from asking the right, and sometimes *tough*, questions.

Outsourcing Benefits. Outsourcing the balance sheet risk management function can provide a bank with many benefits. These include:

- Lower overall costs
- Increased effectiveness
- Reduced business risk
- Value added advice.

Each of these benefits is described in more detail below.

Lower Overall Costs - The cost of in-house balance sheet analyses depends on the functions involved. For the analysis of interest rate risk, these costs usually relate to the following:

- ✓ staffing
- ✓ software purchase and maintenance
- ✓ training
- ✓ subscriptions to rate forecasting and investment analysis services
- ✓ software customization
- ✓ equipment purchase, and
- ✓ space.

Additional expense could relate to:

- ✓ liquidity analysis
- ✓ cashflow forecasting
- ✓ loan prepayment analysis, and
- ✓ investment cashflow analyses.

Once the in-house analyses are completed, the results of these analyses need to be presented in a comprehensive yet understandable reporting package.

When using an outsource vendor, the all-inclusive costs are often much lower than in house. This is because the cost of many of the analytical tools and staffing related costs can be spread across many clients.

Increased Effectiveness – Assuming the right outsource vendor is selected, the use of such a vendor should improve the effectiveness of the data gathering and modeling elements of the processes. While the experience sets of vendors vary greatly, some do have highly trained financial analysts who are full-time data gatherers and modelers, working regularly with a diverse mix of many banks. As a result, they are intimately familiar with common modeling errors and pitfalls, able to efficiently process and reconcile data downloads, and well positioned to question modeling assumptions that may not make sense. They also backtest models to ensure their integrity. The combination of these traits increases the bank's confidence in the accuracy of the results and related risk assessment. *Getting it right* should be priority number one.

Also, when the bank engages an outside vendor, interaction with the various bank departments is much less apt to be met with the same biases or roadblocks that can exist with in-house analysts.

Reduced Business Risk – Engaging an outside vendor to perform balance sheet analyses can often reduce the business risk to the bank, especially if the vendor selected is well established with depth of staffing. For most community banks, there will be one in-house person charged with ALCO responsibilities. If anything should happen to that person, or if they should leave the bank for another position, there usually is no one who can step in immediately to fill their position. Using an outside vendor provides a bank with significant backup and continuity. The use of an outsource vendor eliminates the *one is none* syndrome.

Value Added Advice – Third party vendors are not created equally (e.g. breadth/depth of service) and do not provide the same cost-benefit dynamic. Simply put, their value propositions vary greatly. Accordingly, in evaluating value-add, it is important to look beyond price as the differentiating variable, lest one wants to walk down the confusing path of trying to compare apples, oranges and even lemons, clouding the ability to truly assess the best fit for the organization. In this regard, it is imperative that a bank delineate its needs clearly at the onset.

For example, are you simply looking to outsource the modeling elements of the ALM process? At one extreme, some banks openly admit that they are looking

for little more than to *appease regulators*. The good news is that there are a number of vendors who can help in this regard. Assessing value in this case can be little more than a price consideration, recognizing that the value-add is merely the minimization of an expense.

At the other end of the outsourcing spectrum, many banks understand that a well functioning ALCO process can be a meaningful profit center for their organization. Accordingly, their needs extend well beyond the outsourcing of the modeling and report generation functions, and focus more on the capacities of a vendor to provide meaningful independent advice and counsel. In this regard, when the *right partner* is engaged, these banks find that their ALCO meetings are more productive and that strategy development and implementation are more effective. These banks look at the value-add decision in terms of a return on investment rather than a reduction of an expense.

The value-add can also come from valuable input to the bank's management team and members of the board of directors, in the form of both analytical and consulting support for balance sheet analyses. This occurs in its greatest form when the analysts are professionals dedicated to data gathering and analyses, and the consultants are professionals who interpret the analyses and help the bank develop and implement strategies to improve the bank's risk/return profile. Since the best consultants are constantly involved with capital markets, regulatory issues, and accounting pronouncements, and work continually with a diverse group of multiple bank clients, they are able to bring new ideas for strategies and best practices to each meeting. The experiences should also enable them to provide strategies that might relate to, for example, loan pricing and structure, deposit pricing and product structure, funding strategy, interest rate risk mitigation, liquidity enhancement, increased income, and preparing for the bank's next regulatory examination. In addition, these types of consultants are constantly looking for ways in which the ALCO reporting package can be improved in support of the bank's overall decision-making process, and stand ready to provide necessary ongoing education for bank management and the Board.

Conclusion. The decision to outsource balance sheet analyses is a critical one for every financial institution. Most community banks need to give this subject a realistic review accompanied by a sincere *look in the mirror*. They need to ask the right questions and then answer them candidly. The right questions will create the appropriate focus when assessing the level of in-house expertise, the effectiveness of the process, the total cost of the resources involved, and whether there is a need for

objective third-party advice to support the overall balance sheet management process.

In evaluating outsource vendors, the following checklist may be helpful:

- What is the depth of the vendor's staffing?
- What is the bank's role in assumption development and to what extent can the assumptions be customized?
- Do the simulations cover multiple years in projections (e.g. 5 years, as referenced in recent regulatory guidance)?
- Do the interest rate risk scenarios for earnings simulations include sufficiently stressed scenarios (e.g. 300-400bp)?
- Do the interest rate risk scenarios include different yield curve shapes (i.e. flattening, steepening, etc.)?
- Is there a robust liquidity analysis included in the balance sheet review package that transcends basic call report ratios? How large is the vendor's client base?
- Does the vendor provide on-site support for the review/interpretation of, and consultation on, the ALCO report package interpretation?
- Does the vendor provide recommendations for balance sheet strategies (investments, loan and deposit pricing, funding, etc.)?
- Does the vendor provide simulations of potential strategies when warranted?
- Is the vendor available for consultation in between the regularly scheduled review cycle?

Banking is a risk/return business that requires risk management, not risk mitigation. Having a highly focused and skilled vendor to assist in the balance sheet management process can have significant tangible and intangible benefits. Since Asset/Liability Management is not a commodity business, it is imperative that bankers exercise the deserved degree of due diligence when evaluating the outsourcing of their balance sheet risk management.

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