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ALM models

Effective modeling process more critical than ever

Institutions need to make sure they are utilizing ALM models effectively in today's difficult economic environment, because the consequences of being wrong are more profound than in the past, a modeling specialist warns.

The banks, thrifts and credit unions that are likely to perform well in the future are those that take their ALCO process seriously and adopt a much more sophisticated and comprehensive process.

"There needs to be a recognition that we are in a whole new era of risk management, and you really need to adapt, if you haven't already done so" says Mike Guglielmo, managing director, Darling Consulting Group, Newburyport, Mass.

"This isn't just about meeting regulators' desires—the new business climate demands it," said Guglielmo, who made his remarks during a recent FMS webinar. "The risks and competition are only going to become greater."

Tough exams

However, he also emphasized that examiners have been taking a tougher stance in recent months towards risk-management issues, including ALM modeling.

"We have tough economic times and volatile markets—Washington is seeking answers and putting a lot of pressure on the examiner side to do somewhat of a post-mortem: how did we get here and how do we not let it happen again," he said.

The key issues receiving a high degree of exam scrutiny include non-performing loans, capital preservation, liquidity risks, and IRR. And earlier this year the banking agencies issued major advisories on IRR exposures and liquidity risks, which, among other things, noted tremendous concerns over the possible adverse impact of rising interest rates on earnings.

"By and large the examiners have it right," Guglielmo said. "Their notions are valid for the most part—really what they are looking for is a more proactive (ALM modeling) process."

"We're seeing and experiencing a lot of heavy-handed exams, and we almost get a sense of premeditated downgrades, where examiners in charge on site have some predetermined measure that they must fit their reviews to," he said.

To comply with mandates on modeling, he said that institutions must ensure that: ALM model assumptions are accurate; net income simulations look out beyond 12 months; yield-curve risk is analyzed under different scenarios; and the board is informed and educated about the modeling process.

Examiners have advised institutions to model IRR scenarios that show larger increases in short-term rates, in some cases up 400 to 500 basis points. Such scenarios also should involve non-parallel yield curve shifts.

Unfortunately, examiners are finding an increased number of institutions that don't know what assumptions and data are going into their ALM models, especially when the modeling process is outsourced.

Obviously, it's essential that assumptions used are accurate and appropriate. In fact, the validity of modeling assumptions has become more critical than ever, due to increased balance sheet complexity, more volatile market factors, greater competitive pressures, and less margin for error.

Faulty assumptions

Faulty assumptions, and the modeling of faulty results based on those assumptions, can result in lost revenue, poor financial performance, restatements and credit downgrades. And obviously, examiners will criticize such mistakes, particularly in today's extremely vigilant environment.

Guglielmo said that it's important for institutions to have an ongoing process for reviewing assumptions. Key elements of such a process should include back-testing, historically based studies and analyses, model validations, and stress-testing.

For example, in back-testing the modeler may compare prior projections versus actual results for rolling 90-day look-back periods. The process also may involve review of major variances by portfolio and product, in which the modeler digs down into the data.

In addition, it's important to test the assumptions periodically by utilizing alternative assumptions during model reviews. Such alternative assumptions might be created for deposit pricing and sensitivity, prepayments, changes in growth, and non-parallel yield curves, Guglielmo said.

He noted that the ALCO and senior management are ultimately responsible for development and support of assumptions, and that senior management must create an appropriate level of controls and discuss the need for modification of assumptions on a regular basis. Likewise, it's important for boards to understand, at least on a conceptual basis, what's going on at the ALCO, including the modeling process.

In today's environment, ALCOs need to carefully analyze different potential risk situations and be prepared to take action if the necessity arises, Guglielmo said. You cannot be over-prepared—whether it's for exams, or more importantly, for future ALCO decisions regarding the structure of your balance sheet.

The online version of the webinar is available on the FMS web site under OnDemand Webinars. In addition, other resources related to modeling are available in the Industry News Archive on the web site at www.fmsinc.org. FMU

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