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The “New Norm” in Balance Sheet Management: Developing the “Right” Strategies & the “Right” Process

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The last few years have been an eye opening experience for the banking industry. One of the many results has been a complete rewrite by the regulatory community of its expectations for what constitutes appropriate balance sheet management.

On June 24, I will have the pleasure of speaking at the 2011 WBA/WFL Bankers Convention to share my perspectives on exactly what the “new norm” in balance sheet management means. In addition to providing an overview of the current industry environment (political, regulatory, and economic) I look forward to discussing the key issues facing the industry relative to funding, liquidity management, interest rate risk management and capital planning. Most importantly, having

a quality two hours will enable me to explore timely, relevant and practical current market strategies for lending, deposits, investment portfolio management, capital management/planning, interest rate risk management, and more.

My primary objectives will be twofold: 1) to help you better prepare for your next exam, and 2) for you to walk away with at least one idea that makes your trip to the convention more than worth it.

The remainder of this article is to provide you with some background as to the critical importance of this subject matter. It also enables me to allocate less of our valuable time at the convention on technicalities, and focus more on “where do we go from here” (aka strategy).

Overview

There is a “New Norm” that has raised the bar to new heights relative to how your bank must measure, document and manage liquidity,



interest rate risk and capital. The rules have been changed and exam results continue to demonstrate that regulators expect the bar to be readily cleared. The stakes are too great to risk coming up short. So much so, that I am reminded of a quote from Benjamin Franklin: “By failing to prepare you are preparing to fail.”

Rather than a literal meaning, the word “fail” in the current context communicates the very real prospect for “consequences” associated with the failure to adequately comply with the 2010 guidance on interest rate risk and liquidity risk management.

From data integrity, assumption development, model accuracy/validation, stress testing, risk limits, ALCO reporting, strategy development, Board reporting, and policies, reports from the field reflect that regulators are rolling up their sleeves. They are asking tough questions in order to assess the adequacy of bank interest rate risk and liquidity risk management activities. We have never seen regulators delve into the depths of every aspect of bank balance sheet risk management processes like we are seeing today.

There is a “New Norm” in Balance Sheet Risk Management.

Importance of Being Prepared

I remain steadfast in my belief that it is impossible to over-prepare for your next exam. It is far better to discover that you were more than sufficiently prepared, than wish you had prepared more.

The consequences of inadequate preparation are too severe. And the “rules of engagement” being applied throughout the regulatory community can be quite inconsistent, placing a big premium on being prepared for the unexpected.

Preparing for Your Next Exam

How comfortable would your bank be in inviting regulators to sit in on your next ALCO meeting? We know numerous banks with a well functioning and dynamic ALCO process that “insist” regulators attend their meeting when on-site for their exam. Why? Because it is a home run!

Take control of the balance sheet risk management components of your next exam.

- Be honest with yourselves, thereby enabling your respective bank to shore up risk management processes *a priori* vs. *post facto*,
- Put yourselves in the regulators’ shoes,
- Play devil’s advocate by anticipating “the tough questions”, and
- Document, document, document.

Interest Rate Risk

The old adage “garbage in, garbage out” is alive and well in bank interest risk modeling. Nothing personal, but we continue to be surprised as to how much “garbage” we still see. It is not that difficult to *validate* the accuracy of your *model*. Make sure you back-test the results of your ALCO model by comparing to actual results and documenting an analysis of meaningful variances. Technically, every bank is required by regulation to validate their model/process annually by an independent party (either internal or external).

He/she who controls the *assumptions*, controls the results. A rigorous approach to assumption development is critical, and it should be documented.

Concerns by the regulatory community regarding an appropriate understanding by banks of their interest rate risk position are embodied in the interagency guidance discussion on *stress testing*. Make sure your interest rate risk management activities address this important area of regulatory focus. However, banks need to be sensitive to creating “analysis paralysis” by running so many different scenarios that one creates confusion rather than clarity.

At the end of the day the real purpose of risk management software is **not** to build a model. Rather, it is to facilitate decision-making. Do not underestimate the importance of this distinction.

Liquidity Risk

While the bar has been raised on interest rate risk management, it has rocketed skyward for liquidity risk management (both operating and contingency).

The particulars for liquidity risk management are so dependent on bank specific variables. Accordingly, the following represents a very general guideline of necessary elements which I will provide some color on at the June convention.

- Quantification of both on and off balance sheet liquidity with policy minimums;
- Dynamic cashflow forecasts, including implications of cash shortfalls or excesses;
- Contingency liquidity policy that sounds more like a procedures manual;

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- Contingency liquidity plan that includes:
 - ☑ a risk monitor report
 - ☑ cash flow projections, accompanied by quantification of both on and off balance sheet funding capacity for meeting shortfalls and contingencies;
 - ☑ descriptions and modeling of a series of increasingly stressful financial situations and the potential impact on customer behavior, and availability of wholesale/credit facilities (quantify potential degree and timing of liquidity problems); and
 - ☑ pre-emptive strategies that the bank will implement in response to the triggering of early warning indicators, as well as to avoid/mitigate liquidity stresses reflected in the stress testing exercises;
- Quarterly updates of a contingency plan (more frequent if currently operating with liquidity stress); and

- Board reporting of contingency planning activities, related stress testing results, and required actions, if any.

Strategy Development

The purpose of ALCO is simple: *Strategy Development*. The best ALCOs understand this quite clearly. And so now does the regulatory community, as evidenced in their guidance that puts the industry on notice that they will be examining how risk measurement and analysis is utilized to make decisions.

And this is where I intend to allocate at least 50% of our time together on June 24 including covering:

- Deposit strategies that make sense (products and pricing).
- A mindset for improving loan pricing/product discipline.
- Cash burning a hole in your pocket? Practical solutions are readily available!
- Should I “insure” against rising rates? If so, how much? What manner? When?
- Investment portfolio management strategy in highly uncertain and volatile markets.
- Managing operating and contingency liquidity in the current environment.
- Capital management and planning issues, and more.




Additionally, I will comment on:

- Proven steps to better prepare for your next exam.
- Cliff Notes for understanding Interagency Guidelines on Interest Rate Risk and Liquidity Risk, and more.

Concluding Comments

Yes, there is a “New Norm” in Balance Sheet Risk Management. The days of banks who took interest rate risk and liquidity risk management for granted, and did only what was deemed sufficient to keep the regulatory monkey off their back, are undoubtedly over.

Being successful in meeting regulatory expectations begins with establishing *the appropriate focus* and ensuring that risk measurement activities enable your bank to get the risk assessment *right*. Doing so will facilitate meaningful strategy discussions that culminate in action. And it is the confidence to act that turns an ALCO process from a cost center into a *profit center*.

I look forward to providing you with that one idea (at least) that makes your attendance at **2011 WBA/WFL Bankers Convention** a worthwhile investment of your time. 

Matt Pieniasek is the President of Darling Consulting Group (DCG), working nationwide with financial institutions in the areas of asset/liability management, capital management, strategic planning, and mergers and acquisitions. In addition to assisting in the development of solutions for earnings enhancement and risk mitigation, Matt is active in helping institutions manage through the rigors of the current economic and regulatory environments. He will serve as this year’s keynote speaker at the WBA/WFL Convention at the Suncadia Resort in Cle Elum, WA.


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