



Assessing Your Bank's ALM Risk Tolerance

*How to validate the effectiveness of your
bank's interest rate risk policies and practices.*

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Many community financial institutions frequently ask to have their ALM programs assessed and evaluated. In this competitive and complex operating environment, bank management often desires to validate the effectiveness of their interest rate risk policies and practices.

Unfortunately, we are not always able to provide such judgment because we find that their models do not provide a clear enough picture of the balance sheet's interest rate risk posture. Typically, while these models effectively capture the cash flow and repricing dynamics of the existing balance sheet, they frequently fall short in their assumptions for balance sheet projections.

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This article attempts to reveal some of the assumptions that are most commonly overlooked.

Deposit Mix Is Likely Changing. Most banking institutions are seeing the majority of certificate of deposit (CD) maturities roll into specials (5 percent or above), not low modestly-priced standard CD products (typically 3.5 to 4.5 percent). Also, CD customers that shifted their money into saving and money market deposit accounts in 2001 to 2003 appear to be shifting back into promotional deposit products (CDs or Premium MMDAs). Depending on the degree to which trend is occurring at your financial institution, projected margin levels could be materially overstated in your A/L model. It is also important to keep in mind that most deposit specials are shorter term in nature (less than one year). While this would benefit margins should interest rates fall, more frequent deposit rolls place greater pressure on margins in a rising rate scenario.

Loan Growth is Tapering Off. The buildup in liquidity during the declining rate cycle of 2001 to 2003 has allowed many banks to redeploy investment cash flows to the loan portfolio. Some A/L models appropriately captured this dynamic. As growth has tapered off over the past year, the loan portfolio may no longer be able to absorb this cash flow. A/L models should reflect current cash flow reinvestment strategies accordingly.

Prepayment Speeds for Variable Rate Loans May Be Higher in ALL Rate Scenarios. Be careful when building prepayment assumptions into the A/L model. Many banks are finding that old three- and five-year adjustable rate mortgages are close to their first coupon resets. Many of these loan coupons will be indexed up by the maximum allowable by change cap covenants. Since these fully indexed rates are considerably higher than current mortgage rates, it is likely you may experience a greater rate of prepayments in a flat rate scenario than is currently assumed in your model.

Also keep in mind, as the Fed has increased the targeted funds rate 400 basis points (bps) over the past two years, floating rate borrowers have seen their coupons adjust commensurately. If rates continue to rise and these loans do not have rate ceilings, you may encounter an increase in requests to fix loan coupons, if you have not experienced these requests already. Additionally, current fixed rate loan pricing is below the WSJ Prime rate, or the three month LIBOR plus 270 bp equivalent. Some banks are at risk to see floating rate borrowers solicited by fixed rate lenders.

Floating rate loans may prepay/modify in a falling rate scenario as well. It is important to consider the ability of your financial institution to enforce rate floors on this pool of loans. Will a competitive environment place pressure on you to rewrite these loan structures at lower rate levels?

Liquidity and Deposit Pricing Power. It is always important to periodically reassess the deposit pricing assumptions in your A/L model. Since many banking institutions have lagged deposit rates in the current rising rate cycle, there is likely greater pressure to increase deposit rates if market rates rise further. This will be especially true if your institution has limited resources to access cash should local deposit growth be sluggish. Management likely would not want to worsen the liquidity situation by increasing the risk of attrition due to low deposit rates.

Recognize that the financial institutions that have lagged as interest rates have increased will have less flexibility to reduced rates when the current rate cycle reverses. This increases the risk to falling interest rates.

Will the Yield Curve Remain Flat/Inverted? Interest rates are flat/inverted across all sectors of the yield curve. The law of averages would suggest that the yield curve should return to a more normal slope at some point in the future. It would be wise to include nonparallel yield curve shifts (e.g., steepening or increase in slope) in your interest rate risk analysis. For most, a steeper yield curve is beneficial. In a falling rate scenario, funding cost, tied to short term rates, would likely fall more than cash flow reinvestment yields (tied to longer term rates). If rates rise and the yield curve steepens, cash flow reinvestment yields will rise more than if pressure is placed on funding costs.

Words of Advice. It may be time to reassess how your financial institution's modeling process helps identify both the obvious and hidden risks in your balance sheet.

A recommendation would be that you develop schedules that examine trends in your deposit mix. Draw conclusions about how depositors are reacting to your current product/pricing scheme, as well as the degree to

which your institution may either want to (or need to) price *each* deposit product if rates rise/fall.

Understand the degree to which prepayment options in your loan portfolio will potentially affect cash flow volumes.

The unfortunate reality is that margins are likely to contract regardless of interest rates. Competitive loan pricing and high marginal funding costs mean that most community banking institutions are putting on new assets at considerably lower spreads than those that currently exist on the balance sheet. Your interest rate risk position will either help or worsen this current phenomenon.

A/L managers will not find any silver bullets when it comes to operating in this challenging environment. The best approach is to go back to the basics. Take controlled risks based on what your analysis tells you about your balance sheet's exposures and opportunities.

Remember, your management team cannot control the market environment within which you are forced to operate. You can only control the degree to which you assume risk. This requires you to first understand how effective or possibly inefficient your risk/return profile is.

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As Managing Director of Darling Consulting Group (DCG), Darnell has over 10 years of experience working directly with community banks to help them improve overall performance through proactive management of liquidity, interest rate risk and capital, and by developing strategies that best fit the risk/return dynamic of their balance sheets. Additionally, he counsels institutions that seek advice on enhancing the overall effectiveness of their ALM processes. Darnell is a frequent contributor to professional publications, and has participated in a wide range of educational programs for the banking industry, including the ABA's Stonier School of Banking.

Prior to joining DCG, Darnell was a field office examiner with the Federal Deposit Insurance Corporation (FDIC) in the department of Safety and Soundness. He is received a B.S. in finance from Bentley College and a M.S. in finance from Boston College. Darnell lives in Massachusetts with his wife and twin sons.

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