The Director's Role in Asset-Liability Management

by: George K. Darling, Chief Executive Officer
Darling Consulting Group

Over the past year, there has been increased regulatory pressure for directors to become more involved in their bank's asset-liability management process. Some directors have even been told that they need to understand, in detail, the assumptions in the models that are used to quantify balance sheet risks. These and other regulatory pressures relating to the asset-liability management process are causing angst for many directors, especially since there seems to be a lack of consistency as to what is being communicated in the field by the different regulatory agencies.

Management Versus Director Responsibilities

Once again, it is important for boards of directors to separate responsibilities between management and directors. Webster's dictionary defines a director as:

"A member of a board of persons who control or govern the affairs of an institution or corporation."

There is a fine line between establishing and monitoring guidelines for the operations of a financial institution and becoming involved in the management of the business itself. For directors to fulfill their role, they need to:

- Understand the Profit/Loss Statement,
- Understand the risk/reward aspects of the business,

- Establish guidelines within which risk is managed,
- Monitor compliance with guidelines and regulations,
- Ensure adequate management and succession plan and
- Develop and monitor strategic direction.

A director's role in the asset-liability management process requires an appropriate knowledge of the risk/return aspects of the banking industry in general, and of his or her bank in particular, so that reasonable guidelines can be established for measuring and monitoring risk. Guidelines must be established by the board of directors for liquidity, capital levels and interest rate risk as part of their role in the asset-liability management process.

Once these guidelines are established, the board needs to effectively monitor compliance with these guidelines by ensuring a management process is in place, but not being involved in the process itself.

Director Role in Asset-Liability Management

Once guidelines have been established for managing balance sheet risk, directors need to:

1. Understand the management process. Directors need to understand the process by which balance sheet risks are measured and monitored. Where does the data originate that drives the models and reporting? Is there an adequate reconciliation process? Where do assumptions for loan and deposit pricing come from? Who is involved in the assumption process?

2. Understand "key" assumptions and scenarios. It is impracticable for directors to understand, in detail, all the assumptions that go into the asset-liability management process. On the other hand, it is important for directors to understand the most significant assumptions impacting the results of their risk measurement models. In this regard, directors should understand the range of interest rate scenarios used to test interest rate risks and any key variables that may have material impacts on model results.

Directors need to know that a broad range of reasonable scenarios have been examined in order to appropriately stress test interest rate risk and that both parallel and non-parallel yield curve

shifts have been analyzed. Directors need to understand assumptions used for prepayment/extension risk of assets and the expected behavior of non-maturity ("core") deposits.

3. Independent third-party process review. Directors need to feel confident about the integrity of the asset-liability management process by having an independent third-party conduct and document a periodic review of the process (e.g., annually).

4. Ongoing back-testing. The proof of process/model integrity is whether the modeled outputs approximate actual results. Ongoing back-testing results should be reported to the board.

George K. Darling
Chief Executive Officer
Darling Consulting Group, Inc.
gdarling@darlingconsulting.com
Tel: 978.463.0400 x118
www.darlingconsulting.com

George Darling is the Chief Executive Officer of the Darling Consulting Group (DCG), a firm that provides comprehensive business solutions to financial institutions, primarily in the areas of Balance Sheet Management and Strategic Planning.

Mr. Darling's professional experience includes: thirty years with his own company, two years as a senior executive with a $2 billion financial institution; two years with a Big Five Accounting firm and ten years with IBM. He is a nationally recognized resource for assisting financial institutions in the areas of interest rate risk management, liquidity management and capital planning.

Mr. Darling is a contributing editor to the monthly Bank Asset/Liability Management newsletter, and a co-author of The Business of Banking for Bank Directors published by Robert Morris Associates. Mr. Darling is a graduate of the University of Massachusetts, Amherst, Massachusetts.

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