FMS Update

OCTOBER 4, 2016

Under Pressure

Key considerations for ALCO

WITH the Fed recently holding steady on rates but again signaling a possible move in the near future, community institutions must continue to grapple with the possibility of either an imminent rate hike or a continuation of the historically low-rate status quo, or even worse, lower rates (especially longer-term rates). For many, this leads to a very pertinent question:

How "strategic" is our ALCO?

Frank Farone believes strongly that amid this period of prolonged margin tightening, the answer to this question is likely to be the key differentiator between high-performing and less successful institutions. The Managing Director from Darling Consulting Group recently presented a webinar for FMS in which he reprised his well-received presentation on balance sheet strategies from the Forum in June – touching on a wide array of issues confronting community institution ALCOs, from margin pressures to the importance of core deposit studies and for most, the leverage multiplier as a means of offsetting margin compression.

The *Update* caught up with Farone by telephone after this session to get some additional thoughts on three of the key points he covered. This is an edited version of that conversation.

***FMS Update*: You said that economic value is probably one of the most misunderstood things in ALCO. Why do you believe this to be the case?**

Frank Farone: There is some value to running an economic value of equity (EVE) or net economic value (NEV) calculation. If you have significant exposure to rising rates, it might uncover some of the things that are lurking in the balance sheet that you might not see when you run a five-year simulation. So it has some value in looking at the long end of the balance sheet.

But at the end of the day, the primary focus should be on earnings at risk, as opposed to value at risk – there's a big distinction between these two. It's important to understand what EVE is and isn't telling you. It tells you little about how and when rate changes will actually materialize in a bank's reported earnings. It's also a liquidation calculation – which implies a level of market liquidity for an entire bank balance sheet that simply does not exist.

So while EVE or NEV can be a somewhat useful barometer for trying to capture the structural capacity in the balance sheet, or how much you have in terms of long-term assets, it still doesn't tell you much about your earnings, and therein lies the major flaw.

***FMS Update*: You encourage community institutions to consider wholesale funding. Why do you think more aren't doing it?**

Farone: A lot of institutions simply don't borrow. They consider it to be a sign of weakness or they think the regulators don't like it. But the reality is that every single dollar on their balance sheet is borrowed. A deposit is nothing more than an IOU – it's a borrowing, not equity.

If you believe it's necessary to continue to grow the balance sheet, it's far more expensive to do so using only retail deposits; and the fact is deposits aren't growing that much anymore, so it's easier said than done. A lot of institutions will go out with specials and promotions, but the problem is they might not get enough, or they might get too much and cannibalize their existing deposit base.

Obviously, all things being equal, everybody would rather be fully funded with low-cost deposits, but that's not feasible. It can

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become very expensive to pursue fully funding a balance sheet that way. So if an institution doesn't like borrowing for whatever reason, then by definition it needs to keep a lot of excess cash available in the event that money runs out the door, like if it loses a big account or loan demand picks up. But that money could have been working for them in securities out on the curve or in mortgages – sitting on that cash is just not an efficient way to manage the balance sheet.

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>
> *Frank Farone, Managing Director, Darling Consulting Group*

Wholesale funding is like a just-in-time inventory funds management process for an institution. There's no functional cost for the borrowing – it bypasses all of the costs associated with funding with deposits. The bank also gets to choose exactly how much and what type of funding it wants. It's the lowest cost of funding at the margin, and it allows them to put all of their money to work.

At the end of the day, would regulators rather see an institution with high levels of capital and liquidity in the form of cash and short-term? Of course. They're the insurer of that organization and the more conservative the institution is, the less risk they have (to the fund) and the better they feel. But that's not how to manage an institution effectively. It's a risk business, and you need to take risk to make money. Risk isn't bad, it's a necessity. The key is how banks think about, measure and manage those risks. Unfortunately, a lot of institutions choose to take the path of least resistance so their exams go more smoothly; but I always say if your exam goes that smoothly, you're probably leaving a lot of money on the table.

***FMS Update*: You spent a little time near the end of your presentation talking about derivatives. What would you say to an institution that isn't using derivatives or even considering them as a potential tool to manage risk?**

Farone: The first thing I would do is ask why, in order to understand the impediments; they're almost always self-imposed. Then I would help them understand how much money they are foregoing and/or unnecessary risk they are accepting in their balance sheet because of their decision not to consider derivatives. In the current world of historically low rates and sustained margin pressures, every basis point matters more than perhaps any time in history. Too many banks are unknowingly leaving a lot of basis points on the table.

I think a lot of people go to conferences and hear a presentation about derivatives, and they walk away confused and scared because they think they're way too complex. Or they hear horror stories about situations that really don't have any bearing on the kinds of simple swaps, caps or floors they're going to be dealing with.

But derivatives aren't nearly as complicated as people think, and institutions ignore them at their peril because it's going to cost them a lot more to raise long-term funding if they're not utilizing them. They're really one of the most efficient tools for helping to manage a balance sheet effectively and efficiently and profitably. ■

In Depth

For more of Frank's insights and analysis, be sure to catch up with his recent Best of the Forum webinar "**Balance Sheet Management Strategies for Managing Through a Fed Tightening Rate Cycle**," now available as a replay for purchase in the FMS store at www.fmsinc.org.

FMS Update

FMS Update is published biweekly by
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