Vol. 35, No. 8 August 2019

Bank Asset/Liability Management

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A Risk Management Primer for Today's Banker

An integrated approach to managing risk with a focus on the future

The challenges facing today's bankers are real, but sometimes we only see the tip of the iceberg. With so much to do in only a very limited time, CFOs and risk managers are often left looking for the fastest way rather than the *best* way. And when discussing asset liability management (ALM), taking the fastest route frequently leads to taking unnecessary risks and increased opportunity costs.

My colleagues and I have just spent the past month on the road speaking at various conferences and talking with bankers about what is on their minds. Common themes arose throughout our discussions, including:

- Liquidity availability and contingency planning.
- Deposit pricing pressures, even as the Fed is expected to *pause.*
- The ability to extend assets and hold fixed rate production.

While these topics are top of mind to many of the CFOs to whom we spoke, a significant hurdle they face is educating and convincing their asset liability committees and boards to their importance and the need to take action. The challenges are further complicated when discussions take place in silos. Risk management needs to be an integrated process where the lenders and retail groups must have an understanding of what each other is facing. The pressures the lenders are facing with regard to pricing challenges are exacerbated by the expected increase in deposit rates. Dialogue between these groups is critical in maintaining adequate spreads. Understanding the liquidity options available and upcoming liquidity needs provides clarity, but the communication must occur in order to provide benefit.

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Our sessions expounded upon the issues above, and the importance of integrating each into your ALCO discussions. How these are incorporated into your risk management discussions can have a profound impact on your bottom line while avoiding the potential for decisions to be made without complete information.

Liquidity

Anyone who has experienced a regulatory exam recently knows that liquidity remains a regulatory *hot button*. To understand why, one only need look into the trends to see that key ratios (loans/deposits and loans/assets) are continuing to increase toward levels not seen since the 2007-2008 timeframe. This should not be a discussion based upon how much liquidity you have today. Rather, the focus needs to be on your bank's ability to identify how much ***total*** liquidity it has today in addition to how much liquidity it might need, and what events could occur to cause that to change.

In outlining your discussion on liquidity, industry best practices and regulatory direction suggest that you address the following:

Liquidity Cushion — Resulting from the 2017 FDIC Supervisory Insights, the *cushion* is intended to reflect the most liquid of a bank's liquid assets, to create a buffer of on-balance sheet liquidity. The level a bank is comfortable operating with is a reflection of its approach to managing its liquidity portfolio and keeping its cash at work. It also helps to identify funding opportunities for asset growth (can we utilize investment cash flow to fund the growth or are we reliant on deposit inflows or wholesale alternatives?). A strong cushion allows for a more defensive approach to deposit pricing whereas a tighter position may require the retail team to have more competitive pricing.

Dynamic Forecasting and Stress Testing — Liquidity levels of today can look quite different six months or a year from now. Therefore, the ability of your model to dynamically forecast changes to the balance sheet mix and the accompanying impact on liquidity, while managing the levels of both unencumbered security and loan collateral is critically important. Liquidity management in general and stress testing in particular have become key areas of regulatory focus. Collateral management, along with a funding strategy that incorporates a variety of approved funding alternatives, truly forms the foundation for managing operating liquidity and establishing a resilient contingency liquidity plan and strategy. Your contingency liquidity plan and stress testing should illustrate that you have an understanding of potential events that could cause a liquidity challenge and, more importantly, that you have a plan in place to respond.

Potentially Volatile Funding Sources – When considering the best sources to fund balance sheet growth, wholesale funding (i.e. FHLB advances, brokered deposits) should be a consideration, but due to the nature of these products a prudent liquidity management process includes scenarios that incorporate a reduction or elimination of these resources as part of your contingency liquidity plan. More of a challenge for bankers has been the focus on what the regulators consider potentially volatile deposits – high rate deposits, uninsured deposits, single source concentrations or larger deposits. These funds are considered *at risk* and potentially volatile, yet we have worked closely with many banks to substantiate the stability of these deposits through increased customer level analytics. By demonstrating the strength of the overall customer relationship, the length of time they have been a customer and that their primary relationship is with their bank, bankers are able to defend the core qualities of these accounts with their examiners and help alleviate concerns.

Deposit Pricing

Once your bank's ALCO has a firm understanding of its liquidity levels and needs, deposit pricing strategies become clearer. Stronger liquidity allows for a more defensive pricing posture. Those who deem their liquidity *tight*, may implement a more direct pricing campaign aimed at new deposit balances (through higher priced promotions) while closely monitoring attrition to ensure they are not *treading water* by losing as many deposits as they bring in.

Whether your deposit strategy is more offensive or defensive in nature, it is more important than ever to be able to utilize the vast resources of data at your disposal to help determine the best product and pricing strategies while gauging their ongoing success. Being able to monitor attrition levels and have a means to identify the more *at risk* portion of your deposit base allows your ALCO to be proactive in determining the best product strategy to grow/retain deposits at acceptable marginal costs (which factor in migration or cannibalization).

The effectiveness with which a bank manages its cost of funds plays a big role in determining its financial performance. Fortunately, most banks have been quite successful thus far in reining in funding cost increases as interest rates have risen, due primarily to deposit pricing discipline. However, and notwithstanding a Fed that appears to be on hold, angst is accelerating given concerns that deposit pricing and balance pressures could escalate over the coming year as competition for deposits is expected to increase thereby adding additional pressures to lenders to maintain spread in an ever challenging environment.

Asset Extension

When the yield curve is as flat as we are experiencing today, be careful not to fall into the *trap* that many before you have experienced. It seems almost too good to be true that you can lock in your funding 4-5 years for the same cost or less than short-term alternatives. And on the asset side of the balance sheet, the tendency is to keep the assets, including the loan portfolio, shorter.

In reviewing the interest rate risk profiles of institutions of all sizes throughout the country, we have found that few do not have the capacity to hold long-term loan production. A straightforward review of the amount of longer-term assets being funded with the bank's long-term/core funding finds that most banks are not utilizing the majority of their *core funding* base while having the capacity to portfolio these loans. When examining the interest rate risk profiles for banks over a five year time horizon we find, with few exceptions, that even in the cases of those with a near term exposure to rising rates, the longer-term risk profile tends to exhibit an asset sensitive bias (benefit to sustained higher rates with the most exposure to a falling rate environment).

That type of profile, coupled with the need for increased spread to help offset the expected increase in deposit rates/ funding costs, lends itself to holding on to fixed rate production in the loan portfolio. Those who are truly asset sensitive have the ability to maximize spread with a *mismatch* by funding the loans short. When determining the best course of action to take, it is imperative to identify the availability of liquidity and how such a strategy would change that. In addition, including *pro forma* analysis by running the strategy through the IRR model allows the ALCO to identify the impact on earnings and rate sensitivity.

These three topics that were discussed during our recent time on the road with many of your peers may, on the surface, appear to be unconnected. However, the interrelation between the levels of liquidity a bank has, and needs, directly impacts the strategic focus of the retail group as it relates to product and pricing initiatives. The lenders must also be aware of the impending deposit pricing pressures when determining the loans to portfolio and how this growth should be funded, which is also a factor of the bank's interest rate risk profile and the term of funding options that best fit the position.

A bank that has these discussions in the silos will find the strategic focus can be misdirected and have a negative impact on the bottom line. Those bank managers that take a more integrated approach to risk management will be in position to best optimize margin and earnings while managing the risk inherent on the balance sheet, and remain flexible to take advantage of opportunities as they become available.

— Mark Haberland
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