New RMA Survey Offers Insight into ALM Practices at Community Banks
RMA’s survey succeeded in creating a “sound practices” benchmark for institutions with assets of $10 billion or less.

BY JIM CLARKE AND FRAN GARRETT

RMA’s Market Risk Council and Community Bank Council have released the results of a survey on sound practices in market risk management at banks with assets of $10 billion or less. The survey’s results provide valuable insight into common industry practices and the degree to which market risk techniques have achieved general acceptance and standardization. The final report details the most prevalent methods, tools, and decision processes used in the institutions surveyed and provides opportunities for benchmarking to the sound practices.

Of the 42 institutions participating in the survey, 19 have assets of less than $750 million and 23 have assets larger than $750 million. One-third of the institutions are publicly held stock companies, 47% were closely held stock companies, and three institutions were mutual associations. The sample provided for a wide range of primary regulators:

- 14% are regulated by the Office of the Controller of the Currency (OCC).
- 14% are regulated by the Federal Reserve.
- 12% are regulated by the Office of Thrift Supervision (OTS).
- 14% by state regulators.
- 36% by the Federal Deposit Insurance Corporation (FDIC).
- Three Canadian banks fell under Canadian supervision.

ALM Is Part of Enterprise Risk Management

Enterprise risk management (ERM) is a holistic approach, encompassing all of the risks associated with managing a financial institution. It’s a concept taking hold with regulators and many community banks.

The risks associated with asset/liability management (ALM) are a subset of ERM. Both small and large institutions surveyed focus on liquidity risk and interest rate risk as the essential components of ALM, although the larger institutions also include counterparty risk as a responsibility of ALM. In the current environment, credit risk is the most serious concern for all the respondents, but only one-third consider credit risk as a responsibility of the asset/liability committee (ALCO).

The past three years have been a tumultuous period for financial institutions, and this turmoil is evidenced in the survey results. Credit problems are the overriding concern for all respondents, but especially the larger banks. Asset management has become more difficult as loan demand remains weak for most banks. With the drop in loan demand, 81% of respondents have experienced an increase in liquidity.

Liquidity also has been enhanced by deposit growth: 90% of respondents have experienced an increase in core deposits. Loan-to-deposit and loan-to-asset ratios are down among all bank peer groups, and most institutions in the survey have experienced a decline in these ratios.

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With the increase in liquidity, respondents are becoming more asset-sensitive, and investment strategies are a greater focus of ALM than before. A majority of institutions are holding more cash and are concerned about an eventual increase in market interest rates. As a result, respondents indicated they are shortening investment duration and trying to lengthen liability duration.

It’s also interesting to note that, when asked about examiner scrutiny of liquidity and interest rate risk in recent safety and soundness examinations, 71% of respondents agreed that the level of this scrutiny has increased. This response corresponds to the regulatory initiative in 2009 addressing liquidity contingency plans and the Federal Financial Institutions Examination Council’s 2010 guidelines on interest rate risk.

Risk Assessment and Culture

One section of the survey was designed to gauge the importance, level, and direction of risk within institutions and to understand the prevailing risk culture. In ranking risk, respondents overwhelmingly listed credit risk as number one, followed by interest rate risk and liquidity risk, and
then capital risk and operational risk. Interestingly, when asked about the direction of risk, a majority of respondents were optimistic with regard to credit, liquidity, and capital risks. Indeed, these risks were perceived to be stabilizing or decreasing. But interest rate risk and compliance risk were seen as increasing by more than 35% of respondents.

Another interesting observation was the focus of board members on risk. Respondents noted that their boards' philosophy toward ALM has intensified owing to the external environment and the internal problems their institutions are facing.

Organizational Structure, Governance, and ALCO Process

Another section of the survey was designed to assess the structure of risk management within the organization and the board's involvement in the process. Traditionally, risk management was separated into two areas: credit administration and ALCO. But this structure is changing as regulators focus more on ERM, forcing all institutions to consider a separate risk management function encompassing all major risk types. The concept of a “risk management czar” or chief risk officer (CRO) is becoming more common; 44% of the larger institutions in the survey have a CRO. The importance of this position is evidenced by the fact that 86% of CROs report directly to the CEO.

When asked about the ALCO process, respondents noted that board committees meet on a quarterly basis, whereas management ALCOs meet more frequently, especially at the larger banks. The purpose of the ALCO varies among institutions, but all respondents viewed management of liquidity and interest rate risk as the primary responsibility. Half of the committees are chaired by the chief financial officer. And significantly, more than 71% of respondents view the ALCO as one of the most important committees governing the institution.

Another important aspect of an effective ALCO process is the meeting agenda. The responses concerning agenda items, however, were a bit surprising. Only 71% of institutions include an interest rate forecast in the agenda, and only 62% include a cash flow pro forma. Only 41% of agendas include local economic conditions, even though most loans are made in the local market. The most surprising response is that only 65% of respondents actually make balance sheet decisions at the ALCO meeting.

What seems to be a recurring theme throughout the survey is the need to provide education for ALCO members, both managers and board members. When asked about the effectiveness of their ALCO, more than 80% of respondents were positive. But when asked about the level of understanding about ALM among both nonfinancial managers and board members, the respondents were less positive. But they do believe that education will lead to a greater understanding of balance sheet management, particularly with respect to liquidity risk and interest rate risk.

Risk Measurement

The measurement of balance sheet risk is a regulatory requirement for all institutions. The survey results indicate that small institutions are more likely to outsource their ALM models, whereas large institutions use in-house software for that purpose.

Current regulations require institutions to report their exposure to interest rate risk to the board at least quarterly, and 95% of survey respondents indicated they run the model monthly or quarterly. Larger institutions in the survey are more likely to obtain model results on a monthly basis. Recent regulatory guidelines call for scenario testing, but 50% of smaller institutions indicated that they don't currently model for various scenarios.

The majority of institutions that do scenario testing use the term structure of interest rates as the variable. Most also use a parallel instantaneous shock in interest rates to simulate both the balance sheet and income statement, although more and more institutions are incorporating models that allow for incremental nonparallel shifting of the yield curve. The current low-interest-rate environment also requires larger shocks. Of all the respondents, 66% indicated that their institutions shock 400 basis points or more, an encouraging finding.

In addition, regulators expect an institution to conduct an income statement simulation for at least two years, and 67% of respondents are modeling two years or more. New regulatory guidelines are also stressing back-testing. The RMA survey indicates 75% of institutions back test their interest rate risk models, although only half of the respondents are stress testing their modeling assumptions.

The key to accurate modeling of interest rate risk is the assumptions incorporated. The most important assumptions on the asset side of the balance sheet involve prepayment speeds on mortgage loans and mortgage-backed securities. The majority of respondents apply prepayment assumptions to residential mortgage loans.

On the liability side of the balance sheet, the critical assumptions apply to non-maturity deposits. Respondents believe their most sensitive deposits are money-market accounts and certificates. In choosing decay rates for non-maturity deposits, institutions primarily use their own internally generated assumptions or turn to the OTS assumptions. In simulation models, 74% of respondents use the same beta for rising and falling rates, but the majority of institutions use a lag between a market-rate change and the change in their deposit rates.

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Liquidity Management

All respondents reported having a liquidity policy either separately or as part of their ALM policy. In 2009, regulators began requiring institutions to prepare a liquidity contingency plan. Today, 93% of responding institutions have, or are in the process of developing, such a plan.

For liquidity reporting, the most frequently used documents are:
- Sources and uses statement.
- Liquidity contingency stress test.
- Asset/liabilities maturity.
- Maturity gap.
- Deposit rate comparisons (backup or secondary liquidity was the primary purpose of the investment portfolio).

Sources of liquidity have become a major concern of regulators since the 2008 financial crisis, and they now require institutions to indicate sources of liquidity in their liquidity contingency plans. A disconcerting 28% of respondents had no institutional backup lines of credit, although 33% had three or more lines. Meanwhile, 84% of institutions have federal funds purchase lines. The liquidity contingency plan should also include limits on funding concentrations, and the survey indicates that 59% of institutions have some form of these limits.

The last two questions in the survey addressed the understanding of liquidity management within the institution. Highlighting the need for more education around ALM and liquidity, the typical respondent believes that the board’s understanding of liquidity risk management is only slightly above the midpoint. Managers scored slightly better than board members in understanding liquidity issues.

Management of Interest Rate Risk

A key section of the survey was designed to determine the effectiveness of interest rate risk management within an institution. The survey indicates that the two most important sources of interest rate risk are yield curve changes and mismatching of assets and liabilities. Implied in the results is option risk, which is an important source for residential mortgage lenders and for investors in callable bonds and mortgage-backed securities. Basis risk is not a factor in this sample since all the institutions in the survey have assets of $10 billion or less. If institutions larger than $10 billion had been included in the sample, basis risk would likely have been noted in the survey results.

Among the institutions in the survey, 48% are asset-sensitive and the rest are equally divided between neutral and liability-sensitive. As most respondents expect market interest rates to increase in the future, asset sensitivity is the optimal balance sheet position.

Interest rate risk policy should include board limits for the balance sheet and the income statement. These limits should address the acceptable volatility in capital and income from a change in market interest rates. The two dominant board limits reported in the survey are changes in the market value of equity (77% of respondents) and changes in net interest income (86% of respondents).

Again, when respondents were asked how well boards and managers understand interest rate risk management, boards scored slightly below average and managers were at an average level. The survey results continually and consistently reinforce the need for more education focused on ALM.

Use of Derivatives

The information provided in the derivatives section of the survey was limited because 63% of the small institutions and 17% of the larger institutions in the sample do not allow the use of derivatives. For those institutions that do use derivatives, the three most often are caps, floors, and swaps. While responses vary on the reasons why institutions are not yet using derivatives, the most widely cited were as follows:
- Management is not comfortable with derivatives.
- ALCO and the board are not comfortable with the risk.
- There is a lack of operational infrastructure to handle derivatives.
- It’s easier to hedge the balance sheet through changing asset/liability duration or pricing.

The level of understanding by boards and management is weaker in this area than was the case with liquidity risk and interest rate risk.

Conclusion

The survey succeeded in creating an industry benchmark for institutions with assets of $10 billion or less (although not necessarily for banks larger than that). The results provide “sound practices” validation in the management of interest rate risk and liquidity risk, as well as several other areas for community banks, including organization (ALCO structure), governance (board participation in policy and procedures), and risk management (interest rate risk modeling and liquidity risk management).

The survey also indicates that more education is needed both at the board level and among nonfinancial managers. This conclusion was reinforced in a number of areas, but most importantly in the two most important responsibilities of ALCO: management of liquidity risk and interest rate risk.

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