Northern New England School of Banking

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Asset Liability Management for Banks

DISCUSSION ITEMS:

1. What is Asset/Liability Management?

2. What are the primary objectives?

3. Definition of Interest Rate Risk.

4. Asset Liability Pricing Decisions.

5. Who is responsible?

6. What are their duties?

7. Reports and other metrics.

8. Involvement of Board and Regulators.

What is Asset Liability Management?

Purpose is profit management.

To provide adequate earnings in all “plausible” future interest rate environments.

By managing and controlling interest rate risk and Balance Sheet liquidity.

<u>Definitions</u>

1. Interest rate risk is the risk to earnings from movements in interest rates

    - Direction
    - Magnitude
    - Slope

2. Liquidity is a Bank's ability to raise cash when it needs it at a <u>reasonable</u> cost.

    Balance Sheet liquidity is derived from cash flows on loans, investments, deposits and borrowings.

Primary Objective of Asset Liability Management

To maximize earnings and return on capital within acceptable levels of risk.

Areas of risk include:

- Interest rate risk
- Liquidity
- Capital
- Credit

<u>Interest Rate Risk Positions</u>

<u>*Asset Sensitive*</u>

Assets “re-price” faster than liabilities

Desirable when rates are at the low point of the economic cycle

<u>*Liability Sensitive*</u>

Liabilities “re-price” faster than assets

Desirable when rates are at the high point of the economic cycle

Who is responsible for Asset Liability Management?

Most banks have an Asset Liability Committee, or ALCO, that is comprised of:

Executive Management (CEO, CFO, COO)

Sales (retail loans, commercial loans and deposits)

Investment Manager

Treasurer

Marketing Director

What are the duties of ALCO?

- ✓ Monitor financial results.
- ✓ Review and discuss liquidity position.
- ✓ Review and discuss IRR position.
- ✓ Review and discuss capital levels.
- ✓ Monitor implemented ALM strategies already in place.
- ✓ Review outlook for interest rates and economic metrics.
- ✓ Review and discuss loan and deposit pricing.
- ✓ Develop ALM strategies.
- ✓ Set appropriate ALM policy limits.

Reports and Other Metrics

- Monthly and/or quarterly financial statements
- Interest rate markets, including US Treasury, LIBOR and brokered CD rates
- Competitor interest rate surveys for loans and deposits
- Investment portfolio
- New loan volume
- Loan portfolio balance changes
- Deposit balance changes
- CD maturities
- Industry statistics
- Economic data: national and regional
- Key bank ratios: ROA, liquidity, margin, Tier 1 Capital, Risk Based Capital, asset mix, non-performing loans, loans past due, ALLL, etc.

Board and Regulators Involvement

Board should approve ALM policies.

Board should review ALCO strategies that are implemented.

Regulators will review a Bank’s ALM policies as part of a bank’s Safety and Soundness Examination.

This review will include all aspects of the Asset Liability Management of the Bank.


FRED
10-Year Treasury Constant Maturity Rate
17.5
15.0
12.5
10.0
7.5
5.0
2.5
0.0
Percent
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
Source: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org
myf.red/g/7A2S


FRED
Bank Prime Loan Rate
Percent
22.5
20.0
17.5
15.0
12.5
10.0
7.5
5.0
2.5
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
Source: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org
myf.red/g/7A38


FRED
30-Year Conventional Mortgage Rate©
Percent
20.0
17.5
15.0
12.5
10.0
7.5
5.0
2.5
1975
1980
1985
1990
1995
2000
2005
2010
2015
Source: Board of Governors of the Federal Reserve System (US)
fred.stlouisfed.org
myf.red/g/7xCR