

BANKER'S Economic & Investment ALERT

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Assessing the Balance Sheet Management Process at Your Bank

With the economic outlook uncertain, interest rate-risks and balance sheet complexity increasing, and regulatory scrutiny intensifying, effective balance-sheet management is now even more important because the margin for error is so small. Net-interest margins vary widely within the banking industry. While local market dynamics explain some of the differences, the effectiveness of an institution's balance-sheet management process is also a key factor. The focus should be on developing policies and strategies designed to improve current and future income while managing risk. What distinguishes higher-performing institutions from average banks is their ability to develop and implement forward-thinking strategies based on an assessment of the current balance sheet.

Each bank has a distinct balance sheet and interest-rate risk profile requiring customized strategies to meet management's objectives. Banks must be careful not to oversimplify the strategy formation process; a one-fits-all approach does not apply to balance-sheet management. Timely implementation is also important. Changes in the market or in economic conditions can quickly turn a once compelling strategy into one that is mediocre and may even be counterproductive.

Assessing the management's ability to manage the balance sheet can be an eye-opening experience. We developed a fun 10-minute self-assessment as a quick diagnostic aimed to uncover the

potential strengths and weaknesses of an institution's balance-sheet management process. At a minimum, readers can reconfirm their depth of knowledge of the various balance-sheet management topics discussed in the assessment. More importantly, this may be an opportunity to identify those areas that the management team needs to pursue further. Naturally, a more comprehensive knowledge of the different areas of the balance sheet management process would lead to effective strategy discussion, documentation, and implementation, ultimately resulting in higher profitability and more effective risk management.

The assessment is comprised of eight areas with one sample question from each area of the balance sheet management process:

- ALCO Effectiveness
- Liquidity and Funding
- Deposit Pricing
- Investment Management
- Loan Pricing
- Interest-Rate Risk
- Net-Interest Margin Management
- Capital Management

Each area of the assessment is assigned a certain number of points weighted by their relative importance, as viewed by the authors. Readers may wish to adapt these weights based on their own experiences and their own bank's requirements. This high-level assessment is not a statistical test and is intended only to approximate the strength and the depth of the balance-sheet management process. The amount of information necessary to assess fully the management's ability in more detail is too voluminous to cover in this article. One sample question is selected from each of the areas listed above. Circle all the points that apply and compute a subtotal for each question.

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1. Are specific strategies that require action discussed and documented during a normal ALCO meeting? (14)

Strategy description and discussion	2
Risk/Reward evaluation	4
Implementation	5
Documentation	3

2. Which of the sources below are or could be available? (12)

Fed funds purchased line	3
FHLB borrowing line	3
Brokered CDs	3
FRB line	2
Security repurchase agreements	1

3. Are the following deposit pricing methods utilized? (12)

CD specials	4
Relationship pricing	4
Marginal cost of funds	2
Deposit segmentation	2

4. The investment portfolio is comprised of the following security types: (11)

Callable Agencies comprise less than 30%	3
MBS/CMO comprise more than 25%	4
Municipals comprise more than 15%	4

5. Are commercial loans priced using some or more elements of the following? (13)

Treasury/FHLB rates	3
Competition	2
Credit risk	2
Term structure	2
Prepayment penalty cost	2
Prime swap curve rates	1
Marginal profitability analysis	1

6. Does the interest-rate risk management process at the bank entail? (16)

A written ALM/IRR policy	2
GAP analysis	1
Net interest income simulation	2
Economic Value of Equity analysis	2
Explicit IRR management policy limits	2
Periodic assessment of IRR output vs. policy	2
Periodic review of ALM assumptions	2
Ability to interpret ALM output and explain to regulators	3

7. Can the net-interest margin trend over the past eight quarters be described as (two-part question)? (13)

Consistently above peer	7
Consistently average	4
Consistently below peer due to rapid asset growth	4
Consistently below peer	0
Difference between minimum and maximum NIM over the period less than 60 bps	6

8. Which of the following describes a normal range of the bank's capital ratio? (9)

4-7 percent	9
7-9 percent	8
9-11 percent	7
11percent +	5

Now add up the points from each assessment question, and refer to the table on the following page for your evaluation. A correlation usually exists between the strength and the depth of the balance-sheet management process and the bank's net-interest margin and other profitability ratios.

<u>Score</u>	<u>Process</u>	<u>Comment on Process</u>
91-100	excellent	very efficient and productive
81-90	very good	efficient and productive
71-80	good	may need improvement in select areas
61-70	satisfactory	potential for missed opportunities
60 and less	below average	may mean ineffective and non-productive

Typically, a score above 90 suggests that you have a complete mastery of the balance-sheet management process. Your bank has a highly effective ALCO with strategy discussion, evaluation, and timely implementation. The balance sheet has ample liquidity through a variety of funding sources. The investment portfolio is comprised of good risk/reward securities, resulting in superior performance over time. The management team utilizes a variety of tools in its loan and deposit pricing decisions. The interest-rate risk is well managed within a thorough policy framework and an ALM model suitable for the size and the complexity of the balance sheet. The assumptions are reviewed for reasonableness, and the output is interpreted and documented.

Effective balance sheet management begins with increasing the effectiveness of the ALCO committee by ensuring that its discussions address all vital parts of the balance sheet.

Do not get discouraged if the result of your assessment is a reading below 60. This may suggest an opportunity for the management to increase their knowledge of the various areas of the balance-sheet management process. For some institutions, an improvement from 60 to 70 may translate into hundreds of thousands of dollars in additional net interest income.

Effective balance-sheet management begins with increasing the effectiveness of the ALCO committee by ensuring that its discussions address all vital parts of the balance sheet. The goal is to bring accountability and a proactive focus to the balance-

sheet management process while promoting responsible governance and oversight. A forward looking approach evaluating how different strategies and their risk/reward trade-offs would affect the bank's interest rate-risk profile and profitability is essential. The ability to discuss, quantify, evaluate and document the various components of the balance-sheet management process will demonstrate to examiners that the bank is going well beyond what is required to satisfy the regulators, and is proactively crafting strategies designed to maximize performance while managing risk.

Assets, liabilities, and risk-management are not isolated bank management issues. They form a complex pattern of dynamic interrelationships complicated further by the optionality embedded on both sides of the balance sheet. Making the right balance-sheet management decisions requires an understanding of these issues that goes well beyond the information asset/liability management systems alone convey. While A/LM systems are vital to informed decision making, relying strictly on A/LM reporting to formulate strategies can produce suboptimal results. ■

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