Regulatory Exam Preparation And ALM

regulatory risk management

Summary: We provide you with some things to consider when evaluating the adequacy of your ALM process, as you prepare for your next regulatory exam.

There are a multitude of quotes about being prepared. Whether your favorite is "By failing to prepare, you are preparing to fail" (Ben Franklin) or "Luck is preparation meeting opportunity" (Oprah Winfrey), they all seem to resonate.

In the world of banking, management and boards both know that preparation for any regulatory examination is critical, if you are going to keep everything on track and moving forward. This is certainly true when it comes to areas of regulatory focus like the asset liability management (ALM) process, as the Fed is raising interest rates and margins are seeing pressure.

To help your bank team prepare, here are some things to consider when evaluating the adequacy of your ALM process for your next regulatory exam:

Governance - You definitely will want to know how board policy limits are established. The baseline is to fully understand the basis for any values chosen for those limits. You will also need to know the impact of policy limits on capital adequacy and earnings. Finally, be sure that you will still be in compliance with minimum required amounts if you hit your limits.

Modeling - Next, know who has responsibility for modeling assumptions (ALCO or individual) and be sure to have proper corporate governance over the process. You will also need to ensure that your key modeling assumptions are aggressively challenged and periodically stressed (sensitivity analysis). Also, don't forget to ask if software validations and independent reviews/back-tests are up-to-date.

Deposits - For deposits, you need to know the basis for key modeling assumptions (bank or industry experience). Regulators generally want bank experience used whenever and wherever possible. So if you don't, be thoroughly prepared to discuss why. You will also want to know how non-maturity life/decay rates are calculated as simple open/closed analysis can understate or overstate expected life. Further, you will need to ask if assumptions vary based on age or rate environment. Regulators are starting to look for varying assumptions in different rate scenarios, because that is actually what happens.

Betas - Know how deposit rate betas are derived (regression, other). For those using regression, know whether the correlations are meaningful and make sure all results have been back-tested.

Loans - Different loan classes can make things more complex. Know when asset optionality is or is not being properly considered when calculating prepayment rates. Have you considered prepays and payoffs in the calculation? What about recent trends that may be distorted by charge-off amounts or illiquid refinancing activity? Also, remember to capture whether the calculation considers refinance advantage/disadvantage.

Overall, this is a complex problem to solve, especially as rates, prepayments, and other factors are continually changing. The key is to consider the current environment, where your risks are the biggest, what conversations are happening and where things might go next to help frame your analysis, perhaps.

If you have questions regarding managing risk at your bank, including the impending ALLL changes related to CECL, we are happy to help. Contact our Advisory Team at (888) 399-1930.

OUTSOURCED ALM SERVICES FOR COMMUNITY BANKS

Managing interest rate risk is both art and science. Regulators have raised the bar and community bankers have more to do than there are hours in a day. To see how easy it is to outsource & get expert help, contact us today.

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