

# FFIEC & Your ALCO

*Preparing for the Changing Regulatory Landscape*

Presented by:

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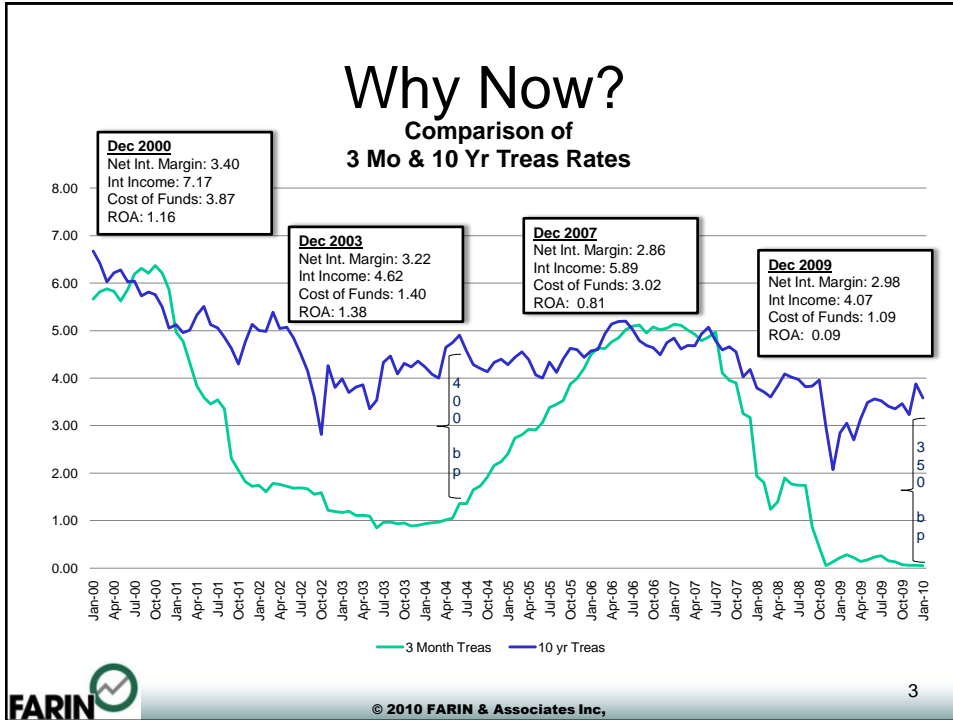
## Why Now

- Margin Decline Due To Bad Debt
  - Increased Provision Expense
- Slope of Yield Curve Incenting Mismatch
- Asset Yields Less Responsive
  - Implementation of Loan Floors limits repricing
  - Loan Performance at risk in rising rate environment
- Cost of Funds Can Only go Up!
  - Increased Pressure on Deposit Growth
    - Low cost DDA/NMDs
    - Regulatory Pressure on Wholesale funding
  - Less asset based liquidity to meet runoff
    - Lower loan repayments due to losses
    - Smaller security portfolios



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2



The time has come to do more in ALCO

## FFIEC IRR ADVISORY

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## FFIEC IRR Guidance

- 2010-1A IRR Regulatory Guidance
  - Issued December 2009
- Generally a restatement of 1996 Joint Agency Policy Statement on Interest Rate Risk
- 3 Major Issues:
  - Effective policies & Governance
  - Effective and Appropriate Measures
  - Meaningful & Adequate reporting



## 1996 Joint Agency Policy Statement - Interest Rate Risk

- Outlines Supervisory Framework Measuring & Assessing Interest Rate Risk
- Guidance on Sound IRR Practices
- Used to Determine Adequacy of Institutions Capital and Risk Management Practices
  - 2 of the major components of CAMELS
- FIL-52-96 Joint Agency Policy Statement: Interest Rate Risk
  - <http://www.fdic.gov/news/news/financial/1996/fil9652.html>



## Joint Agency Policy Statement 5 Areas of Risk To Model

1. Repricing Risk: Impact of mismatch of repricing timing or amount on earnings/capital
2. *Basis Risk: How different balance sheet components respond to market rate movements due to driver response*  
– *Example: Libor vs. Prime movements*
3. **Yield Curve Risk: Recognition that Yield Curves do not move the same amounts for all maturities (non-parallel movements)**
4. Price Risk: Changes in market values of financial instruments and the impact on the market value of capital.
5. Option Risk: Changes to cash flows resulting from rate movements



## FFIEC IRR Guidance

- **Policies & Procedures**
  - Outline how new strategies are tested for IRR
  - Provide controls on permissible strategies
  - ***Ensure IRR is assessed in relation to all other risks***



## ALCO Policies

- Traditional ALCO policy limits for income at risk limit change in margin for +/- 200 or 300 basis point shocks
  - Limit Net Interest Income to -15% of flat rate levels for +/- 2% rate shock
- Assumes all rates move same amount
- Often rates move immediately
- Limit is absolute, no gradients levels of risk
  - Is 3% at risk the same as 13%? Both are under the policy.



## Setting Income at Risk Limits

- **Issue** – If setting Net Interest Margin limit, make sure limit does not allow for **NEGATIVE** net income

Example:

Annual NIM:	\$8,000,000
Annual Net Inc:	\$1,000,000
15% Loss of NIM \$	(\$1,200,000)
<i>Risk Adjusted NI</i>	<i>(\$200,000)</i>

- Adjust limits based on existing level income and all strategic financial goals – annual process
- During times of margin compression, limits are stressed despite no change in strategy



## FFIEC IRR Guidance

- **Policies & Procedures**
  - Modify policy limits to link ALCO actions to risk levels
  - Add graduated risk levels
    - Green – Monitor and Report as Normal
    - Yellow – As measures move towards limit, increase reporting frequency, strategy development, and board expectations
    - Red – Immediate actions required.



## FFIEC IRR Guidance

- **Risk Mitigation Procedures**
  - Outline process for assessing risk & modifying actions as required
    - Progression of institution responses as limits are approached, reached or exceeded
    - Guidance on institution's reliance on Consultants for strategy
  - Use of outside consultant **does not absolve board and management of their responsibilities**



## FFIEC IRR Guidance

- **Internal Controls**
  - *Model Validation*
    - Assess Institution's:
      - Measurement of risk
      - Assumptions
      - Process used in determining risk
      - Back-testing of assumptions and results
    - *Not a test of model mechanics but on ALCO assumptions and accuracy of projections*



## FFIEC IRR Guidance

- **Measurement & Monitoring Systems**
  - Robust IRR process & systems
  - Match size & complexity
  - *If You Outsource **YOU Must***
    - Understand all analytics, assumptions, and methodologies in use
    - Incorporate information and results into
      - Long term (strategic) plans AND
      - Short term (tactical) plans/budgets

*How does that fit how YOU do ALCO reporting?*



## FFIEC IRR Guidance

- *What to Measure*
  - To obtain “Well Managed” rating, must measure both earnings & economic value at risk
  - Must extend simulation of Income at Risk to minimum of 2 years.
  - Guidance opens consideration at last for use of Value at Risk measures on future balance sheets (Dynamic Modeling)
  - When using dynamic modeling, must also run a static balance sheet.
    - Minimize Assumption Risk



## Rationale for Static IAR

### Pros

- Claim is that we are testing the IRR in the existing Balance Sheet
- Claim that Forecasted positions “clouds” the output
- Management may not be committed to the plans



### Cons

- Are we really? Isn't the fact that we are replacing cash flows a dynamic position itself?
- Is a plan that I don't plan to execute valuable in making decisions?
- Can't we back test the assumptions made to ensure actions are consistent with plans?



## FFIEC IRR Guidance

- *What Interest Rates To Measure?*
  - Traditional measures have been shocks
    - +/- 100, 200, & 300 basis points
    - Not enough stress, implied a 400 bp test
  - Rate movements must be both **severe** and **plausible**
    - Must recognize current cycle and possibility for scenario
    - Should consider changes in slope, & twists in curve
    - Who defines plausible?
    - Are parallel shocks plausible?

## REPORTING ALCO RESULTS

## Production Based ALCO

- Interest Rate Risk Levels are linked directly to the speed of flows
  - More asset flows, faster the response to rate movements
- Model Validation is a process designed to ensure proper flow and management assumptions, but
- If ALCO and Budgets are to meet, then the projected flows directly impact earnings and production expectations

## Effective ALCO

- An Effective ALCO Agenda must:
  - Tie current & projected market conditions to plan and performance
  - Address key risk limits set by board in relation to each other, not silos
  - Show level and trend in risk/performance (regulatory framework)
  - Clearly document actions and plans and responsibilities
  - Provide feedback (back tests) of prior plans vs. performance

## Production Based ALCO

### Example:

- Community Bank with 100 million loan portfolio
- Current Interest Rate Risk shows Asset Sensitive
  - More assets reprice than liabilities
- Budget is to maintain loan levels in 2010

### How much volume does the loan department have to produce to stay even in 2010?

- New loans must equal the amount of renewing, maturing and loan repayments
- Using the modeling as a production guide helps keep ALCO accurate and loan department on plan



## Production Based ALCO

- ALM Model Projected Runoff by quarter

	Mar-2010 (Q)	Jun-2010 (Q)	Sep-2010 (Q)	Dec-2010 (Q)
Mortgage Loans	5,920.2	4,215.8	4,255.9	3,216.0
Other Loans	16.1	14.3	12.9	11.6
Total Loans	5,936.3	4,230.1	4,268.8	3,227.6

- By discussing the projected inflows on loans, model is being “validated” for reasonableness each ALCO meeting
- Similar report showing planned originations, including renewals, helps set targets and drive discussion of
  - Products (Fixed/Variable, Balloon/Full Amortizing, etc)
  - Rates (Need to integrate good pricing model)
  - Strategy (Liquidity needs, deployment of excess funds)



## Dynamic ALCO

- To prove to examiners that you can manage the impact of projections on risk levels you must
  - Be able to demonstrate accurate projections
  - Document variances, causes and impacts on performance
  - Prove timely actions are taken and projections are rerun showing new performance levels
- ***If a tree falls in the forest and there is no one there to hear it, how loud was the noise?***

Make the move...

**PUTTING THIS SESSION TO  
WORK**

## Top 5 To Do's

1. Upgrade Policies, Procedures & Limits
  - Limit gradients
  - Test limits
  - Establish limits on non-parallel rate movements
2. Incorporate Non-Parallel Shifts
3. Incorporate Dynamic & Static Balance Sheets
  - Validate loan cash flow projections
  - Review actual monthly/quarterly volumes to projected
4. Add EVE/NEV measures on projected balance sheets
  - Identifies impact of future strategies on long-term capital at risk.
5. Extend Income at Risk Horizon to minimum of 2 years
  - Measure components of margin to determine causes of volatility
  - Develop strategies based on components not margin alone

