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Balancing Qualitative & Quantitative Analysis in Interest

IRR management is about effectively managing your bank's balance sheet. The last few years have taught us to expect what we had thought were low probability, high impact events while preparing for remedial action if the risk probability increases. This approach has forced A/L managers to look at the environment on a quantitative and qualitative basis while taking a more realistic look at the economy & the potential alternative yield curve scenarios. Years of financial growth combined with market instability has led A/L managers to determine how much overarching risk tolerance their bank may have while keeping their business risk profile within an acceptable range. Quantitative ALM is part of this process of determining how much risk management can tolerate in their banking operations. Ideally, A/L managers want their banks to be capable of effectively managing credit, liquidity, operating, & interest IRR in order to take advantage of potential business opportunities. Over the years, this strategy has led to a greater reliance on automated financial & risk management modeling tools. The growing complexities in ALM, combined with greater uncertainty surrounding earnings & capital requirements has reinforced this use of ALM modeling. More importance is being placed on the need to balance quantitative & qualitative analyses to avoid quantitative domination.

A/L managers must rigorously question & interpret their modeling results to gain a clear understanding of how to apply their modeling results to the current risk environment. Although A/L managers often focus on *what the regulators want*, the correct focus must remain on the bank's customer base as well as shareholder needs. This heightened focus is required to ensure the bank's continued growth & survival.

One area that is ripe for a marriage between quantitative & qualitative analysis is the traditional approach of using parallel rate shocks on the analysis of EVE & earnings simulations. Analysis such as *yield curve twist* for prescribed curve movements should also be addressed. By examining interest rate changes of 10, 25, or 50bps within years 2-10 can help ALM analysts understand the next level of risk their bank may face. Basis & volatility risk should also be considered. However, the object of IRR modeling is to move toward using ALM & IRR as balance sheet management tools while enabling

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bank management to prepare for the changes which will most certainly occur in future markets & environments.

How often have you seen parallel rates occur in nature? Although they may occur, yield curves historically tend to flatten at higher levels with increased economic activity & steepen at lower levels as the economy weakens. Interestingly enough, in the current environment a parallel shock in the US Treasury curve might be one potential result of a dollar or fiscal crisis, rather than a traditional economic rebound from a low interest rate environment. Moving beyond quantitative calculations toward proactive balance sheet management requires more work. Understanding the current economic drivers & deciphering their meaning in terms of future realistic yield curves is critical. This information can then be used to develop strategies & tactics which will help A/L managers discern how they may want to manage their banks' investment portfolios while adequately funding book & equity positions. It will also help management focus the bank's limited resources while prioritizing them toward higher probability movements in the yield curve... both up and down.

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To read this article in its entirety, see the September 2010 issue of
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