

ALM Policies: Make Them Better for Everyone

June 2020



Presented by:

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ALM Policies (or ALM Policy Sections)

- IRR
- Liquidity
- Contingency Funding Plan (CFP)
- Investment
- Optional: Capital
- Overlap: Model Risk Management



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ALM Policy Development

- What we've learned...
- Regulatory guidance and expectations
 - ALM guidance is often general and subjective based on risk profile
 - Industry convergence in IRR, liquidity, and CFP policies
 - Best practices
- Policy language often needs some customization (not always)
- Appropriate policy risk limits should be customized to institution



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ALM Policy PITFALLS

- Too long with unnecessary content
 - Modifications to satisfy “this one examiner from several exams ago”
 - Include dissertation on the history and importance of ALM
- Technical policy exceptions
 - Must do everything policy says, even if not otherwise expected/required
- Not aligned with reporting
- Too technical and jargon-y
- Grammar/spelling errors!?



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ALM Policy PITFALLS



- Policy limits
 - Too many/few policy risk limits
 - Risk limits and measurements not defined
 - Policy limits too permissive or restrictive
 - Policy limits not summarized in one section

Characteristics of Strong ALM Policies

- Establish a streamlined framework for reporting and monitoring
- Provide flexibility
- Customized to institution
- Easy to read and digest
- Clear responsibilities and risk limits
- Consistent with regulatory guidance
- Reviewed and approved at least annually by BOD

ALM Page Counts

- Range of page counts from our clients' policies that have passed exam scrutiny
 - LOW: 3 sentences related to IRR in ALM Policy
 - HIGH: 46 pages just for IRR Policy
- Our sample policies (including 1 page each for notes and special considerations)
 - IRR: 3 pages
 - Liquidity: 4 pages
 - CFP: 3 pages
 - Investment: 6 pages (plus 3 pages for STRs and credit monitoring forms)



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ALM Policy Considerations/Decisions

- ALCO structure
 - Board versus management-level (or both)
- ALCO ALM responsibilities
 - Establish ALCO members, meeting frequency, etc. in each policy?
 - Reference one master ALCO charter in separate policies?
 - Combine all ALM policies into single ALM policy with ALCO responsibilities?
- Include early warning indicators in addition to risk limits?
- Include performance targets (i.e. ROA, ROE, NIM, etc.)?
- How to best integrate with MRM, ERM, and other related programs?



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IRR Policy Structure

- Purpose/overview
- Board, ALCO, management responsibilities
- Regular reporting requirements (at least quarterly)
- Special reporting requirements (at least annually)
- Supplemental analysis
- Risk limits
- Governance/controls



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IRR Policy Limits

- 12M and 24M EaR (net interest income) up to +400bp
 - Static balance sheet with instantaneous rate shock
 - Net income should be evaluated if meaningful levels of rate sensitive noninterest income/expense identified (approx. > 10% gross profit)
- EVE up to +400bp
-  GAP
- Additional limits optional based on areas of elevated risk levels
 - Example: 30YR Fixed Mortgages < 20% of total assets
 - Example: Notional value of swaps < 250% of total equity



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IRR Policy Limit Considerations

- Net income policy limits
 - Consistent with net interest income limits?
 - Continue to include without meaningful levels of rate sensitive noninterest income/expense (< 10% of gross profit)?
- What to do in falling/negative rate shifts?
 - Model limitations?
 - Disregard unrealistic scenarios?



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IRR Policy Limit Considerations

- Do policy limits reflect risk tolerance and risk capacity?
 - Too generic (10%/20%/30%/40%)?
 - Too precise (3%/7%/11%/14%)?
- Should limits be progressive?
 - Static (20%/20%/20%/20%)
 - Irregular (15%/25%/25%/25%)
 - Wide range (5%/25%/50%/75%)
 - Narrow Range (18%/19%/20%/21%)



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IRR Policy Limits Considerations

- Limits for net interest income should be related to structural earnings
 - Convert net interest income to breakeven net income
- Determine risk tolerance for IRR
 - Consider non-IRR buffer



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IRR Policy Limits for EaR

- Structural Earnings

Net interest income (no provision)	=	\$ 100 million
Net Income	=	\$ 30 million
Breakeven net interest income at risk (results in net income of zero)	=	30%
- Possible appropriate policy limits
 - 10%/15%/20%/25%
 - Tighter: Less risk appetite or elevated other risks
 - Looser: Temporary reduction in earnings or very high capital levels



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IRR Policy Limits for EVE

- More difficult to test due to nature of calculations
 - Regulatory capital not a perfect substitute for EVE
- Example: Bank could absorb an immediate 25% reduction in regulatory capital and remain “well capitalized”
 - Policy limits may exceed this number, recognizing that regulatory capital will be impacted primarily by earnings over time rather than an immediate fair value adjustment



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IRR Policy Limits – Sample Table

Change in Market Interest Rates	Maximum Net Interest Income Exposure 12 Months	Maximum Net Interest Income Exposure 24 Months	Maximum EVE Exposure
+/- 100 basis points	-10%	-10%	-10%
+/- 200 basis points	-15%	-15%	-20%
+/- 300 basis points	-20%	-20%	-30%
+/- 400 basis points	-25%	-25%	-40%

“Due to model limitations, unrealistic downward rate shifts may be disregarded in certain low-rate environments if the rate shift causes simulated rates to fall meaningfully below zero.”



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Liquidity Policy Structure

- Purpose/overview
- Board, ALCO, management responsibilities
- Measurements and definitions
- Permissible funding sources
- Cash flow forecasts and stress testing (may be in CFP)
- Supplemental analysis
- Risk limits
- Governance/controls



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Liquidity Policy Measurements and Limits

- Standard
 - Primary liquidity ratio
 - Total liquidity ratio (incl. available off-BS sources)
 - Wholesale deposits ratio
- Common (Useful?)
 - Loans to deposits
 - Net noncore funding dependence ratio (NNCFD)
 - Liquidity Coverage Ratio (LCR)
- Policy limit counts
 - Client range between 1 - 22 liquidity policy limits
 - Our preference is between 3 - 5 policy limits
 - Include in cash flow forecasts to make static ratios forward looking
 - Additional measurements can be tracked without policy limits
 - Not all KPIs need a limit



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Liquidity Policy Limits Considerations

- Relevance of various measurements
- Risk management versus regulatory expectations
 - Target primary liquidity ratio?
- Are “hybrid” measurements needed that include cash flows?
- Define and manage core, noncore, surge, customer, wholesale, etc.?
- Is cash flow forecasting strong enough to reduce policy limit count?



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Liquidity Policy Limits Sample Table

Liquidity Ratio Measurements	Early Warning	Policy Limit	Max/Min
Primary Liquidity Ratio	15%	12%	Min
Total Liquidity Ratio	30%	25%	Min
Wholesale Deposits Ratio	10%	15%	Max

Note: Early warning indicators may not be useful if the institution is planning to target a much smaller buffer above the 12% primary liquidity ratio policy limit.



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Contingency Funding Plan (CFP) Structure

- Purpose/overview
- Responsibilities
- Range of liquidity events
- Warning indicators
- Cash flow forecasts and stress testing (may be in Liquidity Policy)
- Activating the CFP
- Funding sources, planning, and response
- Appendix: Funding contacts and instructions



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CFP Considerations

- Dedicated CFP Committee or just use ALCO?
- How is the CFP activated and deactivated?
- Backup roles?
- Early warning indicators sufficient?
- Early warning indicators formally tracked?



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CFP Considerations

- Do stressed cash flow scenarios appropriately include extreme stress?
 - Net losses
 - Falling below “well capitalized”
 - Credit stress
 - Deposit runoff
 - Brokered deposit restrictions
 - Rate caps
 - Reduced secured borrowing capacity
 - Revoked unsecured borrowing capacity



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Investment Policy Structure

- Purpose/overview
- Responsibilities
- Individual transaction authority and limits
- Authorized investments and unsuitable investments
- Approved dealers
- Required pre- and post-purchase analysis
- Accounting (AFS, HTM, trading, OTTI, CECL)
- Internal controls



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Investment Policy Considerations

- Policy appropriate for portfolio size, trading volume, and complexity?
- Procedures and controls sufficient?
- Limits match risk tolerance for credit risk, concentrations, etc.?
- Not allowed to rely solely on credit ratings from NRSROs
- Updates for OTTI and CECL at implementation:
 - AFS: OTTI eliminated; credit losses recorded through allowance
 - HTM: Subject to CECL
 - Trading: No changes
 - Effective 12/31/20 for PBE and 1/1/23 for other inst. (subject to change)



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Takeaways

- ALM policies should clearly define streamlined and flexible programs
- Avoid common pitfalls
- Don't be afraid to start from scratch
- Contact us for the following sample policies:
 - IRR
 - Liquidity (incl. reports)
 - CFP
 - Investment (template only)
 - Model Risk Management (template only)



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Questions?



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