May 2011

Asset Liability Management (ALM) Good Practices

Proportionate research into ALM practices at small and medium sized banks and building societies

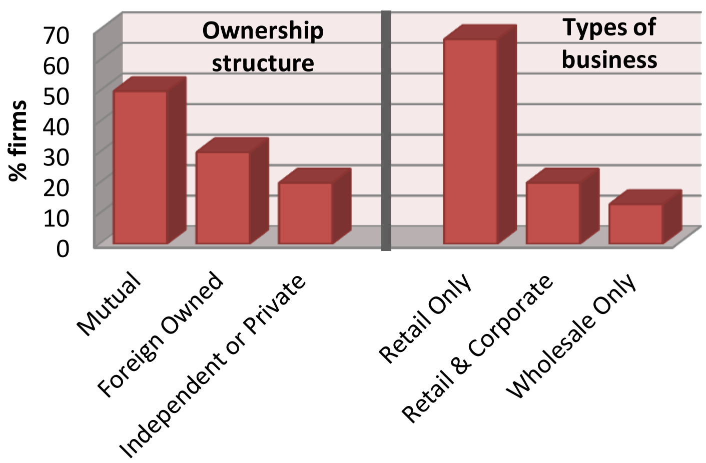
Introduction

The Asset Liability Management Committee (ALCO) is considered one of the most important committees used to run a bank. ALCO has a material bearing on decisions, tactics and strategy covering not only financial stability but also the future direction of a bank's financial performance.

Recognising this, in January this year, FSA head Colin Lawrence wrote to all UK Bank and Building Society CEO's giving guidance on good ALM practice.[1] Much of this guidance was directed at the UK's largest and most complex institutions.

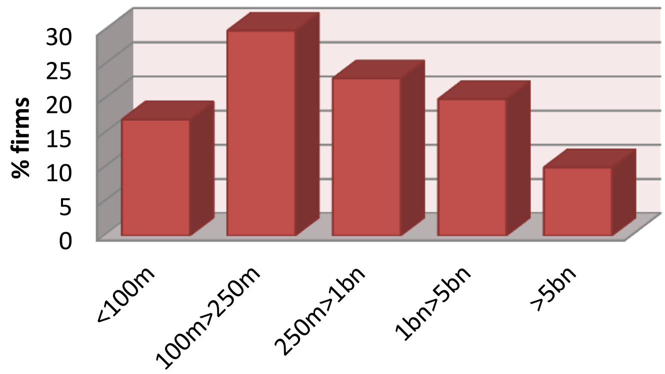
ALMIS International, as experts in Asset Liability Management, have now completed extensive research specifically examining the practices of smaller regulated firms. The outcome of this research will help small and medium sized banks consider their own ALM practices proportionately and relatively to their peers.

Firms surveyed



We have sampled 30 firms involved in both retail and commercial banking, with various ownership structures and assets sizes ranging from less than £100m to greater than £5bn, excluding the UK's larger and more complex banks.

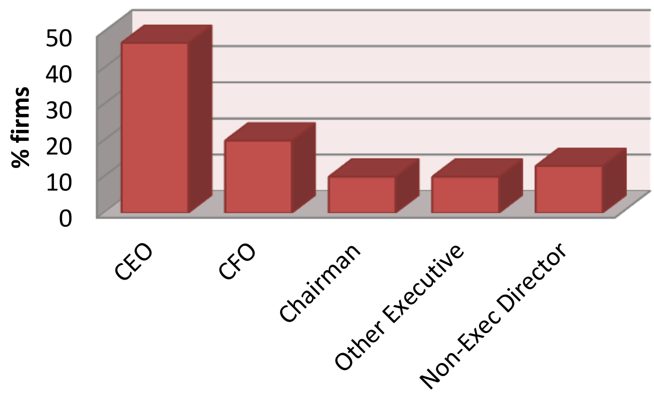
Asset size of firms surveyed (£)



Structure of ALM meetings

The person chairing ALM meetings and the frequency of meetings varies across firms surveyed. 60% of firms have ALM meetings chaired by either the Chief Executive (CEO) or Chief Finance Officer (CFO).

Who chairs ALM meetings?



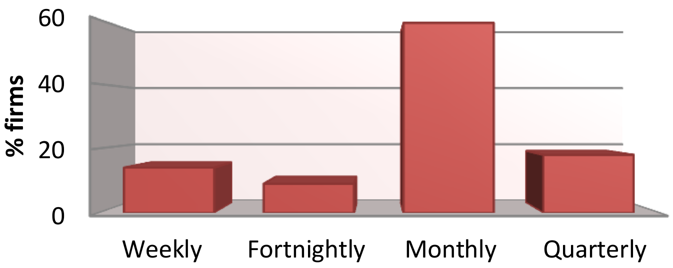
Most firms held meetings monthly, whilst others held them quarterly, fortnightly or weekly. Surprisingly, many of the banking institutions holding meetings more regularly were amongst the smallest in asset size.

[1] Practice Guidance, 17th January 2011, http://www.fsa.gov.uk/pubs/international/dceo_alm.pdf

Copyright ALMIS International Limited 2011, All rights reserved

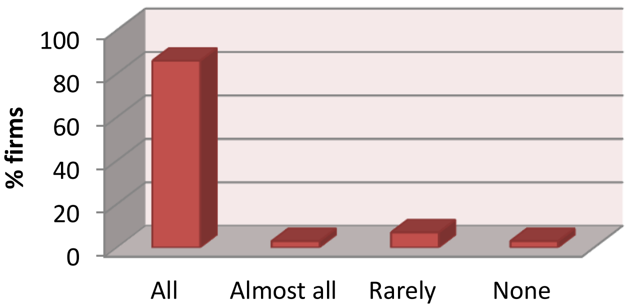
TEL: 0131 452 8898 EMAIL: info@almis.co.uk WEB: www.almis-int.com

How often firms hold ALM meetings



83% of firms have the CEO attending every ALM meeting, with only 7% stating that the CEO attends very rarely. Moreover, the vast majority felt meetings were more effective when the CEO attends.

Attendance of CEO at ALM meetings



FSA recommends that business heads as well as the CFO, Group Treasurer, Chief Risk Officer, Head of Market Risk, Head of ALM, Chief Economist and Head of Internal Audit should attend ALM meetings. No firm surveyed had someone in all these positions and firms felt the composition of ALM meetings need to be proportionate to the size of the firm.

No firm had a chief economist present, and only 27% had someone from audit present at ALM meetings.

"31% of firms did not have any business heads attend meetings"

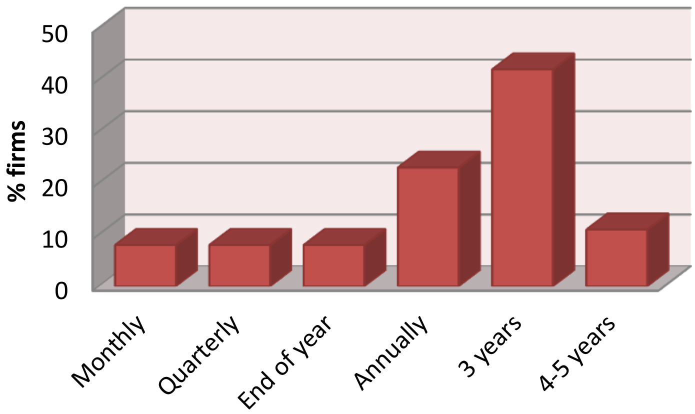
However, those that did have business heads present did not necessary have **all** business heads attend, with some attending only occasionally.

How forward looking is your ALCO?

There appears to be no overall consensus on how far into the future firms should be looking. The majority of firms project for 3 years, although some look at forecasting the next month in detail whilst others project five years.

A major concern of going too far into the future is the quality of projections – a common statement is 'who knows what's going to happen in 5 years time?' A short time horizon has the advantage that the information being produced is far more meaningful and therefore more likely to be used in decision making.

How far forward are firms projecting



"A significant 93% of firms have more historical reports in their ALCO pack than forward looking reports"

Furthermore, 36% of firms devote less than a fifth of their ALCO pack to forward looking reports.

Although firms may not have many forward looking reports, they do spend more time discussing the future. However, firms still tend to focus discussions on the past rather than looking ahead. Only 21% spend more time talking about the future than the past, with 29% spending an equal amount of time discussing the future and the past.

As many as 38% admitted that they felt they were not spending enough time analysing and commenting on the future.

"76% of firms use spread sheets for forecasting"

Of those firms using spread sheets for forecasting and planning, many did admit that it was an inefficient use of senior resources and there was scope for efficiency improvement. Of the 40% of firms who felt spread sheets

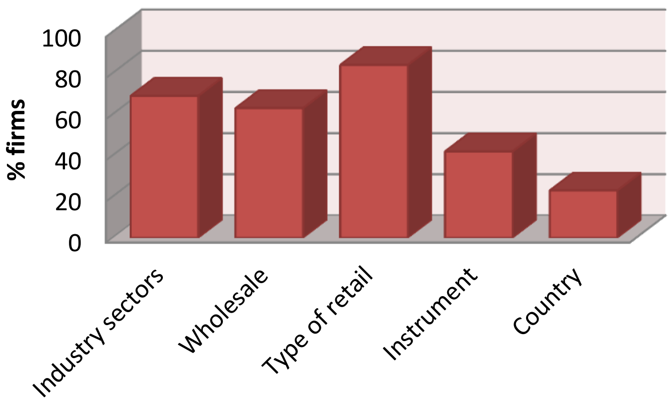
Copyright ALMIS International Limited 2011, All rights reserved
TEL: 0131 452 8898 EMAIL: info@almis.co.uk WEB: www.almis-int.com

were not adequate for looking ahead, half of those were currently reviewing other systems.

Liquidity & Funding Risk

It is considered good practice by the FSA for banks and building societies to look beyond maturity profiles and the mismatch ladder. 93% of firms agree with the FSA and look beyond the maturity profile.

Types of funding concentration firms look at



It would appear that the most popular funding concentration that firms consider is type of retail funding, closely followed by industry sectors.

79% of firms did not consider any other wider risks but those that did considered areas such as; by currency, hot deposits, particular counterparties, distribution, and rate basis.

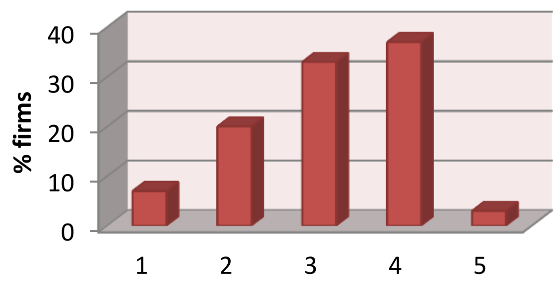
Interest Rate Risk in the Banking Book

The FSA recommends that firms use a number of techniques for measuring and managing interest rate risk in the banking book. Most firms surveyed use four techniques for analysing and measuring interest rate risk, closely followed by three. Very few use only one or all five.

The most popular technique used for analysing interest rate risk is Basis Risk (BR), closely followed by both Scenario Stress Testing (SST) and Net Interest Income (NII).

The main reasons stated for using basis risk for analysing interest rate risk is because it is the focus of the regulator.

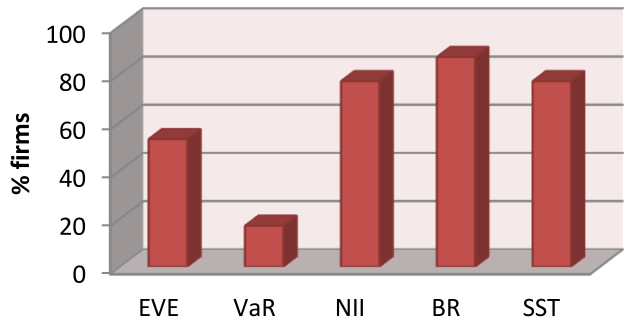
Number of techniques used by firms



The least popular method for analysing interest rate risk is Value at Risk (VaR).

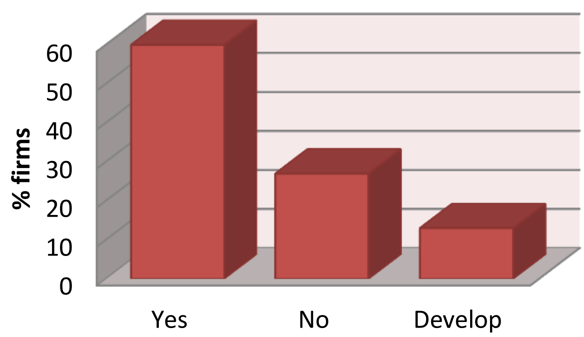
Most firms did agree that using more than one measure was useful as the different techniques give different information leading to better decision making.

Techniques used by firms



60% of firms take account of behavioural assumptions in interest rate risk with 13% stating that they are going to develop behavioural assumptions for interest rate risk management in the future. However, there is still a significant number that have no plans to take account of behavioural assumptions.

Are behavioural assumptions being used by firms?



Copyright ALMIS International Limited 2011, All rights reserved

TEL: 0131 452 8898 EMAIL: info@almis.co.uk WEB: www.almis-int.com

Most firms that take account of behavioural assumptions are looking at either prepayments or pipeline. Other types of behavioural assumptions being examined are the behaviour of borrowers and savers, rollover of accounts, age of savings accounts, withdrawal by type of product and by account.

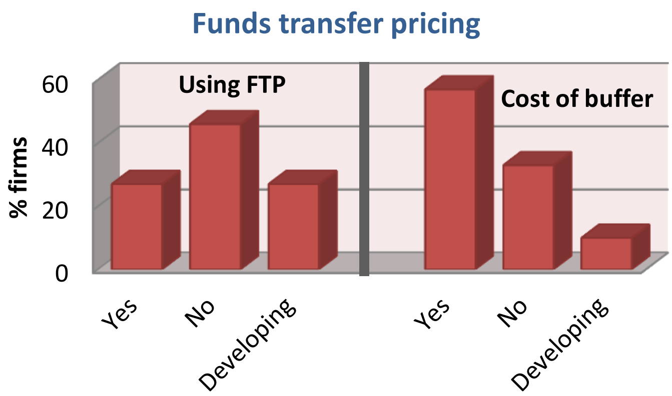
Over 60% of firms are calculating non-interest rate drivers such as changes to the competitive landscape. There is also a significant proportion discussing non interest rate drivers but not actually calculating the potential effects.

Funds Transfer Pricing

Slightly more than half of firms surveyed said they did, or were, developing Funds Transfer Pricing (FTP) for either lending or saving rates.

Only 57% of firms are calculating the cost of holding a liquidity buffer in funds transfer pricing, and only 10% are developing processes to enable them to calculate the cost of holding a liquidity buffer in the future.

Most firms using FTP admit that they need to improve their current methodology. Some firms discuss FTP out with ALCO. Others stated that they do not use FTP due to their size and simplicity.



Liquidity Reverse Stress Testing

77% of firms are calculating the circumstances which would 'break the bank' (reverse stress testing). However, 61% of those performing reverse stress test said they were only performing these tests on historical balance sheets.

76% of firms are using spread sheets for ALCO reports and liquidity stress testing. Many admitted that spread sheets have limitations and their processes need to be improved.

Acknowledgement

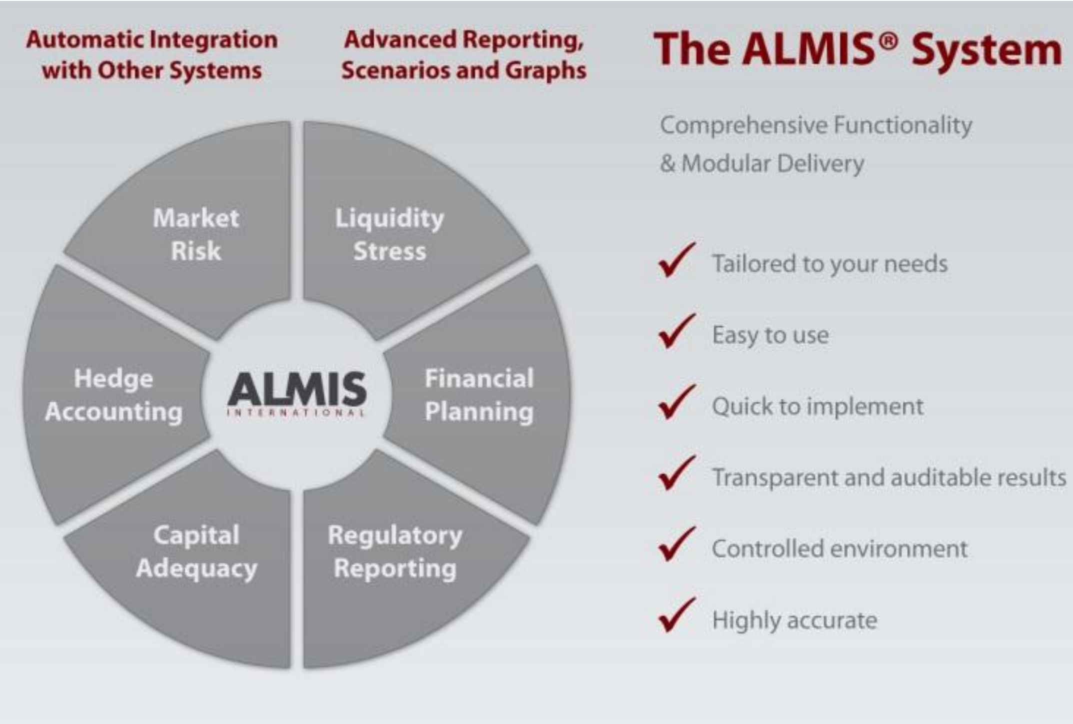
ALMIS International would like to thank everyone who participated in this research. All individual responses are being kept strictly confidential.

About ALMIS

ALMIS International is the market leader in financial risk management systems specifically developed for banking institutions. ALMIS has the largest installed client base of UK regulated firms managing many billions of assets, liabilities and derivatives.

With proven expertise in complex accounting, regulation reporting and ALM analysis, combining market, liquidity and credit risk, ALMIS is highly regarded by firms and regulators.

Contact 0131 452 8898
info@almis.co.uk



Copyright ALMIS International Limited 2011, All rights reserved

TEL: 0131 452 8898 EMAIL: info@almis.co.uk WEB: www.almis-int.com