



In the last four weeks, the ALMnetwork participated in four bank risk management conferences. We spoke with hundreds of bankers and representatives of all five U.S. financial institution supervisors. We found that the current concerns of bank ALCOs and bank supervisors are aligned:

- **Liquidity management**
- **Risks to income and capital based on market conditions**
- **Credit risk concentrations**
- **Basel II & Economic Capital**

**Liquidity management**

In good times, liquidity management is not a hot topic for many banks. In riskier times, like 2008, liquidity becomes a hot topic for bankers and regulators alike.

Regulators are strongly suggesting that bankers updated and test their Liquidity Contingency Plans (LCP). We agree and suggest that *ALCOs should have Liquidity Contingency Plans that deal with both bank-specific and system-wide events.* Bank supervisors, in both public and private conversations, have noted that banks that do not have plans addressing both types of risks will be strongly advised to do so, as this is a safety and soundness issue.

**Risks to income based on market conditions**

Many ALCOs are considering likely near-term consequences of current market conditions.

Market risk and credit risks are increasingly intertwined, as seen recently in CDO, CMO, swaps, and syndicated bank loan markets. Spread volatilities in these markets have resulted in many investments (and loans) priced well below par for an extended time. Banks need to address whether this is a temporary condition or the dreaded “other than temporary impairment” (OTTI). In addition to internal bank and external auditor reviews, bank supervisors are reviewing whether OTTI concerns will impair capital. In a potentially volatile rate environment, with futures and forward rates

trending upwards, there exists the potential for additional price deterioration. *ALCOs should consider the likely impact on projected income and capital across projected rate scenarios as part of the income simulation process.*

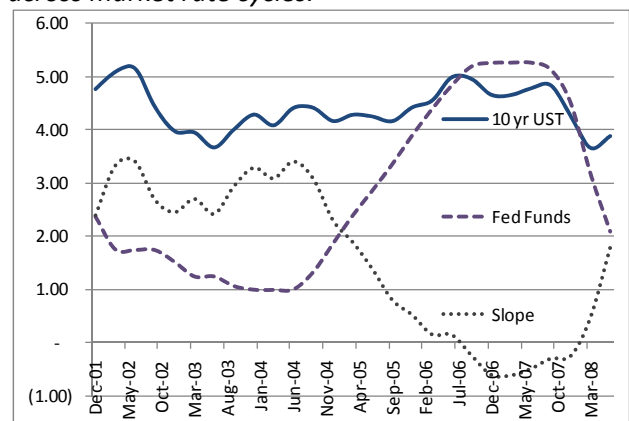
At this point in the credit cycle, users of both business and personal (or home equity) lines tend to draw down their lines. For example, banks that typically run at a 40% drawdown rate may reasonably expect this to increase to a 50% drawdown rate, or higher. Given that incremental drawdowns are likely to have more credit risk than existing balances, *ALCOs should consider the impact of line of credit drawdowns on projected balances, as well as income and capital via the loan loss allowance and write offs.*

ALCO reporting has several various objectives:

- Regulatory compliance
- Risk measurement
- Risk management
- Forecast & profit planning

ALCO reports designed for minimal regulatory compliance usually use interest rate projections based on parallel yield curve shifts. That is, all rates change by an identical amount, like -2% and +2%.

Over the past eight years, Fed Funds rates have varied by over 4%, whereas ten-year rates have varied by less than 2%. Accordingly, we suggest that *ALCOs use yield curve shifts of 4% in short rates and 2% in long rates to assess their earnings exposure across market rate cycles.*





# Asset/Liability Columns

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## Credit risk concentrations

Another hot topic for bank supervisors is the concentration of credit risk in both investments (CDOs and whole loan CMOs) and loans (commercial real estate and lines of credit). ALCO, as the balance sheet management team leader of the bank, is responsible for both risk-based pricing and asset allocation oversight.

Marketplace observers have seen residential real estate values decline in almost all markets, with drops of over 50% occurring in some markets. As a result, banks with credit risk concentration exposures that are 3 or more times capital may be subject to ongoing regulatory surveillance. In addition, the potential increase in loan drawdowns noted above can also result in increased credit risk concentrations.

Again, we concur with regulators that ALCO, as well as other committees, *should analyze these credit risk exposures on sector, credit grade, and transition basis and consider the likely impact on projected income and capital via the loan loss allowance and write offs.*

## Basel II & Economic Capital

Basel II & economic capital have been hot topics in banking for a long time. The Bank for International Settlements (BIS) first gave notice in June 1999 that it would be updating the 1988 Basel Accord. In the past week, U.S. bank regulators gave notice that they were proposing that they would implement the standardized approach of the Basel II Capital Accord, on an optional basis, for those banks not subject to the advanced approach.

Economic capital has several definitions:

- Measures risk to income and/or value
- Economic Capital is buffer for Unexpected Losses (UL)
- Method of allocating capital as part of value creation and performance measurement process
- Approach to estimating capital levels (Basel II)

It is worth noting that the credit risk issues noted in this issue all have economic and regulatory capital implications under the Basel II standardized approach. For example, increased residential LTVs due to lower real estate values result in additional capital requirements. In addition, riskier commercial real estate activities may require capital in excess of 8%. Finally, there are specific requirements for undrawn lines that may result in additional capital requirements under certain circumstances. Nonetheless, *we strongly suggest that banks implement the standardized approach on a pro forma basis in order to analyze the likely impact on their bank.*

## About the ALMnetwork

The ALMnetwork team works with bankers to provide innovative, yet practical, balance sheet management perspectives and solutions. 215-572-8670 or [info@almnetwork.com](mailto:info@almnetwork.com)  
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The ALMnetwork has worked with banks on updating and reviewing their Liquidity Contingency Plans at the request of managements, Boards, and bank supervisors. We provide training and education on Liquidity topics to bank ALCOs and Boards and bank conferences.

For the past four years, the ALMnetwork team has been working with U.S. banks on implementation and training issues related to the Basel II standardized approach and economic capital issues. Later this month, we are presenting a two-day seminar on “Economic Capital Modeling Analysis & Measurement.” Details on this seminar can be found at: <http://training-sa.co.za/workshops.htm>

In addition, we are presenting a two-day seminar on “ALM Model Audit & Validation.” This seminar is sold out, but please contact us at [info@almnetwork.com](mailto:info@almnetwork.com) for additional information on this topic and other upcoming presentations.