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Bank Asset/Liability Management

Prepared by Peter Mihaltian

What to Expect from IFRS 9

On July 24, 2014, the IASB issued IFRS 9 which addresses accounting for financial instruments. The standard has a mandatory effective date for annual periods beginning on or after January 1, 2018 with earlier implementation dates permitted. IFRS 9 represents a significant overhaul to hedge accounting, compared to IAS 39, and better aligns the accounting treatment with an organization's risk management activities.

While many organizations have been working diligently to implement IFRS 9 in advance of its mandatory effective date, there is still some confusion on how IFRS 9 differs from IAS 39. The table on page 2 summarizes some of the changes that are relevant to hedge accounting that bank asset/liability managers can expect when switching from IAS 39 to IFRS 9.

Despite the significant overhaul with IFRS 9, some concepts found in IAS 39 have been preserved; these include the following:

- The three types of hedges remain the same - cash flow hedge, fair value hedge, and a hedge of a net investment in a foreign operation.
- Hedge effectiveness is still measured and all inefficiencies are recognized in profit and loss.
- Hedge documentation is still required to be maintained.

Due to its complexity, time requirement and resource requirement, successful IFRS 9 implementation is expected to be challenging for those that hedge and want the favorable accounting treatment available from IFRS 9. Given this, many organizations started early with implementation programs and many also chose to early adopt IFRS 9. Those that have delayed implementation of IFRS 9 can learn from those that chose to early adopt. The benefits that appear to be most appreciated by those that chose early adoption are reduced P&L volatility, more risk management options and a general

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Area of Change	IFRS 9
Hedging instruments	Allows organizations to designate non-derivative financial assets and liabilities that are accounted for at fair value through profit or loss (FVTPL) as hedging instruments.
Hedged items	Allows the following instruments to be classified as hedged items which would not have qualified under IAS 39: 1. Exposures that combine a derivative and an eligible hedged item (i.e. an aggregated exposure) if the exposure is managed as one exposure. 2. Financial instruments in the fair value through other comprehensive income (FVOCI) category. 3. Components of certain financial and non-financial items (i.e. a contract price that is based on a commodity price plus a fixed percentage, where an entity may hedge the commodity price component with a non-financial hedged item).
Hedge effectiveness testing	Outlines more principal-based criteria for determining hedge effectiveness with no specific percentage thresholds. The focus is on the following: 1. The economic relationship between the hedged item and the hedging instrument. 2. The effect of credit risk on the economic relationship. 3. The hedge ratio of the hedging relationship.
Rebalancing	If the quantity of the hedged item or hedging relationship changes for risk management purposes, the current hedge relationship continues. One caveat to this is that the hedge ratio for hedge accounting purposes must change to align with the new hedge ratio for risk management purposes.
Discontinuance	Can only discontinue hedge accounting when the qualifying criteria are no longer met.
Accounting for time value of options, forward elements of forward contracts, and foreign currency basis spreads	The option amortizes over the term of the hedging instrument, similar to what can be done with transaction costs.
Management of credit risk using credit derivatives	An entity can designate a financial instrument with credit risk exposure as measured at fair value through profit or loss (FVTPL) if certain criteria are met and the entity uses a credit derivative to manage the credit risk.

competitive advantage. Below is more detail on the benefits the early adopters are realizing.

Reduced Profit & Loss Volatility

Many hedges that did not qualify for hedge accounting treatment under IAS 39 may now qualify under IFRS 9. Under IFRS 9, organizations may be able to designate the component of a non-financial item in a hedge. Doing this, P&L volatility can be reduced as the changes in fair value of the derivative likely can be posted to equity. To do this, it is necessary that the component of the non-financial item be separately identified and reliably measured.

Additional Risk Management Options

Under IAS 39 many organizations did not hedge with instruments that included optionality. One of the primary reasons for this was the fact that the time value of the option had to be posted in P&L, thus introducing unwanted volatility to earnings. IFRS 9 allows cost of hedging to be treated as a separate component of equity. Costs of hedging includes the time value of options, as well as currency basis and forward points, introducing more creative hedging strategies as viable risk management tools. Among early adopters of IRFS 9, there has been an increase in the use of options for hedging purposes.

Competitive Advantage

Many early adopters of IFRS 9 have moved away from

hedging risk on a silo basis to applying dynamic risk management approaches. By being able to assess correlations among exposures in multiple asset classes through detailed analytics, organizations are able to better understand their respective drivers of risk. This helps those responsible for risk management to avoid over-hedging, to decrease their cost of hedging and to limit their counter-party risk.

While many organizations have been working diligently to implement IFRS 9 in advance of its mandatory effective date, there is still some confusion on how IFRS 9 differs from IAS 39.

When an entity has decided to take advantage of the favorable accounting treatment available from applying hedge accounting under IFRS 9, one item of particular importance is for the hedger to create hedge documentation that considers current and future hedging strategies and maximizes the likelihood that the hedge will not fall out of effectiveness at some point in the future. While IFRS 9 does not specifically define hedge documentation, what should be written into the document each time a new hedge is established are the following:

- The risk management objective and why the hedge was established.
- Details on the hedging instrument.
- Details on the hedged item.
- Explanation of what risk is being protected against.
- The type of hedge that is being established *(cash flow, fair value or net investment in a foreign operation).*
- How hedge effectiveness will be assessed *(quantitative versus qualitative testing, and details on the testing methodology).*

One of the biggest mistakes that organizations make is to apply hedge accounting without sufficient or well thought out documentation. If the documentation is insufficient from the beginning, this usually will be discovered by the company's external auditor, and they will not allow for the favorable accounting treatment available under IFRS 9, in the company's financial statements.

Another common mistake is creating hedge documentation that is overly specific, or too general, both of which can cause an entity to have to *de-designate* a hedge, and no longer realize the benefit of hedge accounting. Considering how the hedging program may evolve over time should be considered and drafted into the hedge document to provide adequate flexibility and minimize the risk of de-designation.

Another common mistake is to create the hedge documentation subsequent to the hedging program's start. While the IFRS 9 accounting guidance does not define a fixed period of time when the documentation should be established, it is best practice to prepare the hedge document at the inception of when the hedge is put in place. For those that are running a dynamic hedging program, the hedge documentation can be satisfied by creating a master hedge document that broadly covers the entire dynamic hedging program, and to create separate addendums when each new hedge is established. This can cut down on the cost and time that goes into hedge documentation.

The other decision that must be considered is whether to have the hedge accounting prepared internally or outsourced. The hedge accounting tasks can be broken into two distinct categories - pre-hedge implementation and post-hedge implementation. A company can decide to handle all of these tasks internally, handle some internally and outsource the rest, or to outsource all activities.

The scope of this article does not discuss the benefits of outsourcing these tasks versus maintaining these tasks internally, but rather to highlight the need to decide who will do what. It is not uncommon for a company to work with an outside consultant to establish the hedge accounting program and prepare the hedge documentation, and for the company to handle the quarterly testing and reporting. However, some companies may find the quarterly testing and reporting to be burdensome and a poor use of resources, and instead outsource to a company that has systems to efficiently accomplish this work. The point being that every company will have unique needs. These needs must be understood prior to implementing a hedge accounting program, and decisions need to made to assign responsibilities.

In summary, IFRS 9 creates a unique opportunity for organizations that have avoided hedging because they could not get the favorable accounting treatment, or did economic hedging and accepted the introduction of volatility to their earnings. Through the enhancements provided by IFRS 9, many more organizations will now be able to realize the benefits that come from favorable accounting treatment that is achieved when properly applying hedge accounting.

— John Trefethen
HedgeStar

Organizational Considerations in Establishing Your Bank's ALM Function

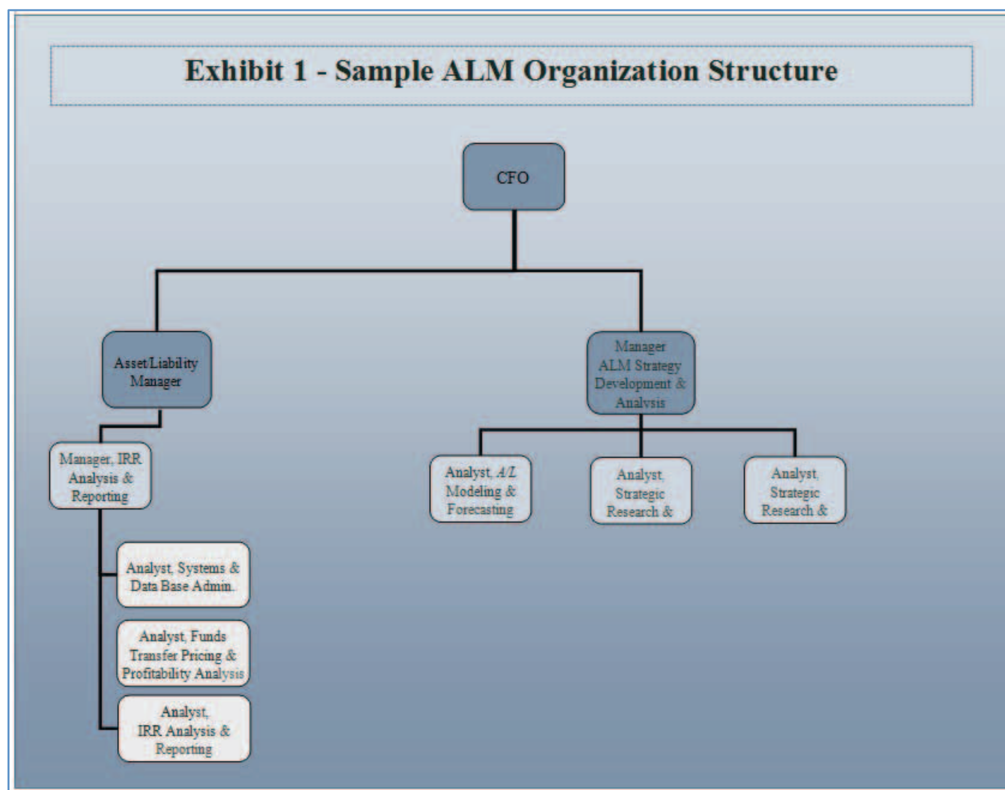
Designing and implementing an effective ALM organizational structure is a key step in the success of a financial institution's soundness and ultimate profitability. Outlined in Exhibit 1 is a sample organizational structure that a number of financial institutions have implemented and found successful, and the indications are that many other financial institutions are moving in this direction as well.

The three basic priorities of this structure are (1) clearly defining the objectives of an asset/liability management organization, (2) realizing the process required to meet those objectives, and (3) defining the qualities and skills required of a successful *A/L* manager. The crucial role played by senior management in establishing and effective ALM function is also examined in this article.

The ALM Process

There are five primary objectives, each addressed by a question, that raise the issues necessary in determining a sound *A/L* management process. To establish and maintain a highly effective ALM organization, critically important issues must be addressed by senior management as well as the *A/L* manager. In an ALM process, the objectives that must be achieved are so intertwined that, if just one is not realized, the entire process is at risk, as well as the financial institution in general. The primary objectives of an ALM department are to answer the following five questions:

- *What happened?* This is answered through systems, data issues, and construction of the current balance sheet.
- *Why did it happen?* This question is answered by quantifying the sources of interest rate risk (IRR) in the current balance sheet and identifying the amounts attributable to various risk factors.
- *What if?* This question is answered by interacting with senior management and business unit managers, building, testing, and forecasting future scenarios.
- *How can we most effectively communicate our current and planned risks so that the problems and solutions are best understood by management?* To address this question, the *A/L* manager must have the ability to comprehend and translate complex problems and recommendations into a language that is understood and completely absorbed by senior management.
- *Who can best answer these questions?* The right professional in the right position can mean the difference between success and failure on the part of ALM in achieving the financial institution's long range goals.



What happened?" and "Who can best answer this question?

In the organization chart, the responsibility for answering the question "*What happened?*" is given to the professional with the title of Manager, IRR Analysis & Reporting. This person manages the process of measuring everything that happened yesterday and before. The specific responsibilities of this manager include *A/L* systems implementation and interaction, data management, and building a valid representation of the

current balance sheet and *A/L* model. If this manager's job is done well, the institution can correctly identify its current risk exposure. If the job is done poorly, management could be making dangerous decisions based on false information.

Additional responsibilities of this position include funds transfer pricing, profitability analysis, and the production of internal and external reports. Generally, the people who perform best in this function have asset/liability management and measurement experience in their background. They will also have successful experience with some elements of accounting, systems, or other closely related fields. Implementing asset/liability management software, constructing data feeds and using that data in countless productive ways are examples of the experience required when attempting to answer the question, *"What happened?"*

Accounting and systems deal mostly with absolutes and have an orientation toward details. So does answering the question, *"What happened?"* Gathering, orchestrating, deciphering and channeling overwhelming amounts of data is an extraordinary task. There is a logical progression when going from building the institution's current balance sheet to analyzing the profitability of products. The data required to perform this function is also more absolute than abstract. A strong and confident ability to handle and control details is necessary.

Why, what if and who is best qualified to answer these questions?

The questions *Why* and *What if* are closely tied together. The answers to both questions have a higher degree of subjectivity and ambiguity than the questions discussed previously. The answers are not nearly as concrete. In order to realistically approach the subject of *What if?* it is imperative that the individual understand why something happened in the first place. The responsibility for answering these questions is given in Exhibit 1 to the Manager of ALM Strategy Development & Analysis. This person manages everything that happens today and going forward.

Specific responsibilities of this manager include understanding balance sheet objectives, quantifying current and proposed IRR, and developing and recommending strategy to business unit managers and senior management; the ability to work closely with strategy implementation teams is also mandatory. Moreover, this manager must also play a proactive-role in acquisition and divestiture activities.

The ideal candidate would have both an *A/L* measurement and strategic development background. The candidate would be experienced and successful in developing hedging strategies using derivatives and working with business unit managers in determining risk and return on new products. Experience in risk assessment and acquisitions/divestitures is also critically important.

In an ALM process, the objectives that must be achieved are so intertwined that, if just one is not realized, the entire process is at risk, as well as the financial institution in general.

The need to measure and manage ever more complex financial instruments is creating new options and motivations in many financial institutions today. The term *value at risk,* OAS analysis and Monte Carlo simulation are now fundamentally part of today's bank asset/liability manager. Today's stockholders now want to know why their institution is using derivatives. It is important to clearly understand the requisite differences between the individuals chosen to answer the questions *Why* and *What if?* Asking experienced *A/L* strategists to invest significant time on issues related to systems, data and report generation would fail to utilize them to their best ability.

How can we most effectively communicate our current and planned risks so that the problems and variable solutions are best understood by management? and Who is best qualified to answer and deliver on this question?"

The responsibility for answering and delivering on these questions belongs to the *A/L* Manager. With rare exceptions, this manager is the best informed individual regarding the details of the balance sheet and the bank's risk management strategies as well as management's objectives. If the *A/L* Manager is unable to effectively communicate an answer to the foregoing questions, then the hard earned answers to the three previous questions may prove useless.

By understanding the financial institution's history and integrating the strategies explored for tomorrow, the A/L Manager will be qualified and prepared to supply options that effectively execute and communicate management objectives.

An individual who can integrate the complexities of a balance sheet and communicate them successfully to management is a rare find. The supply of *A/L* Managers who are experienced at managing an *A/L* process, quantifying and analyzing complex risks, and developing sound strategies to manage these risks and who also possess the ability to know how to hire the right people, is limited. Of

these, only a small minority are also gifted with effective communication skills.

Issues for Senior Management

Ultimately, it is the *A/L* Manager who is responsible for providing answers to the five questions. With such critical responsibilities, it becomes imperative that an *A/L* Manager demonstrate possession of commensurate qualifications. Few can accomplish this, and many of those are currently content in their present positions, leaving the search for these qualified and experienced people ongoing. Recruitment efforts have been known to stall and end in utter frustration because of the lack of candidates with the required qualifications. Recruitment processes are often complicated because senior management has not understood the critical role played by the *A/L* Manager in the success of an organization.

After hiring an experienced *A/L* Manager, senior management is required to periodically review the investment of this manager's time. The most productive ALM processes are managed by an individual who is able to invest a majority of time in strategy development and implementation. Inefficiencies in ALM processes are aggravated when they are managed by an individual who is focused more on details than on strategy.

Final Thoughts

A sound ALM process works effectively and aggressively towards communicating information to senior management thereby yielding informed decisions. Staying focused on the five questions can help senior management and the *A/L* Manager to achieve that objective.

In summary, senior management should follow the following guidelines:

- Do design and implement an ALM structure that leverages the specific skill sets of the bank's *A/L* Manager and staff.
- Do remember that for the strategist to perform effectively, the professional responsible for data management also must perform effectively.
- Do be clear to candidates about the priority senior management places in the ALM process. Failure to do so could result in attracting less than adequate candidates.
- Don't be left without an answer to each of the five questions.
- Don't forget that effective communication is the key to a successful process.
- Don't assume that a candidate bases decisions solely on the size and stature of the financial institution.

— Deedee Myers, Ph.D., MSC, PCC
DDJ Myers, Ltd

Effective Communication With Your Board of Directors

Asset/liability (A/L) managers live in a world that has its own language. Bids, offers, GAP, simulation, EVE, underlying assumptions and other such terms may make communication simple between practitioners of the art of asset/liability management (ALM). However, these terms often confuse the non-ALM practitioner. Unfortunately board members are often among those confused non-ALM practitioners.

In order to implement the asset/liability structure desired or to achieve the optimal risk profile, the bank asset/liability manager must be able to effectively communicate goals, methodologies, and desired results to the bank's board of directors.

This article will focus on the responsibilities of the directors, the type of information they require in order to make informed business decisions whether in a formal board meeting or in a casual presentation.

Responsibilities of the Board

No member of management should ever doubt the intelligence or commitment of any board member. Generally experts in their own field of endeavor, banking directors give time and talent, often for little or no remuneration. Regulatory agencies hold them to a high standard of performance and, in accepting a directorship, the individual places personal financial resources and reputation at risk.

Among other things, it is the board's responsibility to be aware of the institution's operating environment, monitor operations of the institution, and oversee business and marketplace performance. Problems arising from failures in any of these areas represent, in the eyes of the regulatory agencies, the board's failure to properly exercise its oversight responsibilities. Such failure can result in the imposition of personal civil money penalties on the director(s) held responsible.

In order to protect the board from this liability, it is the responsibility of the A/L manager to provide full review of the performance of the portion of the institution entrusted to him or her and to provide information needed by the board

as, in consultation with management, it provides strategic direction and helps to establish risk management policy.

Of course, this is easier said than done. Not all board members are interested in the arcane points of asset/liability management, and eyes begin to glaze over at the very mention of optionality or Boolean distributions. There is no need or expectation for all directors to be expert in such minutiae. What's more, most directors have the intellectual ability and interest to follow a well-ordered and well-documented presentation on almost any subject.

In order to make responsible decisions in the areas of ALM or investment portfolio management, board members need to understand the impact of the proposed action on both the earnings of the institution and the present value of equity. They need to know that the action is within the bounds of regulatory restrictions as well as internal policies and procedures. Management must describe the steps to monitor and measure the results of the proposed action and provide this information to the board through time.

The Importance of Communication

Good communication begins with a structure that encourages communication. While the board as a whole is responsible for measuring and monitoring the risk management process, there undoubtedly are individuals on the board who have greater talent, expertise, and interest in these areas. They should form the board committee (ALCO) reviewing the interest rate management process.

Such a structure provides members with a more intensive education and a forum where in-depth reporting and individual interaction with management can occur. Such committees should meet at least quarterly, with more frequent meetings as needed in the early stages of the educational process. ALCO members are then able to act as liaison and as experts with the full board. Management should also be willing to set aside as much time as individual directors need to become conversant with the subject matter. The better informed the directors are, the greater will be the trust and confidence in supporting the A/L manager's recommendations and initiatives.

Rules for the ALCO

Common sense rules should be followed for all meetings with directors whether in full board, ALCO committee, or individually. These fundamental rules should include the following:

- Provide members with an agenda and binder of information three to five business days prior to the meeting.
- Keep complete minutes of all meetings and provide copies to all participants for correction within a week following the meeting.
- Provide sufficient background material so that the information presented is in context.
- Tailor the presentation to the time available. It is better to schedule additional meetings and fully address one or two topics than to attempt to cram too much information into one meeting and confuse the issues at hand. For the benefit of both management and the directors, it is important that there be no misunderstandings.
- Be certain that backup copies of all information to be referenced are available at meetings. Inevitably a participant will have neglected to bring needed information.
- If using a computer and/or audio-visual equipment, be certain the equipment is set up and working before the directors arrive.
- If possible use color graphics to support tabular information. For busy directors who may be unfamiliar with the concepts at issue, a picture is truly worth a thousand words.
- To the extent possible, standardize reporting so that directors become familiar with important measures and can easily visualize period-to-period changes.
- If there are problems, or if results are less than expected, confront the issue fully. Never hide, whitewash, or sugarcoat a problem or concern. Directors can deal with problems; they cannot deal effectively with surprises.

The bank asset/liability manager must be able to effectively communicate goals, methodologies, and desired results to the bank's board of directors.

Communicating concepts of A/L or investment portfolio management to directors is more difficult than other issues in the financial environment. Many such issues are not intuitively obvious. Even the best financial educators have difficulty explaining why there is an inverse relationship between interest rate movement and price in a bond portfolio, why an instrument with a long maturity has the greatest price volatility, or why an upward shift in interest rates may increase future income while reducing present value of equity. If possible, when discussing such concepts, keep groups

small so that sufficient interaction is facilitated. Use graphics, movement, and imagination to enliven the discussion, and be prepared to go back over items in several different ways so that sufficient understanding is achieved. Examples are always useful. If possible, try to relate the concept to issues or examples outside the financial institutions industry with which the directors may have more familiarity.

The Communications Summary

There is no standard package of directors' reports that will satisfy every situation. It is up to management to design information and means of communicating that will meet the needs of each director. Time spent in understanding the needs of each director and insuring that each director is fully informed is time well spent. As solid communication evolves, the trust that directors have in the management team and their willingness to move forward with management initiatives will increase.

— David Brewick
FIM Associates

2018 Asset/ Liability Management Compensation Survey

While the U.S. financial services industry has continued to strengthen after the 2016 presidential election, the uncertainty of the last several years has underscored the critical importance of bank asset/liability and interest rate risk management. These developments have led government officials, regulators, and industry leaders alike to emphasize a renewed focus upon risk management within the financial institutions industry. What's more, regulatory requirements are being rethought and fundamentally revised with the goal of reducing reporting complexity and systemic risk to our banking system.

Accordingly, the board of directors and senior management of U.S. financial institutions are reexamining their approach to risk management, including their asset/liability management frameworks, governance, and methodologies. At many institutions, boards of directors are taking a more active role in providing oversight of their ALM and risk management functions. Enterprise-wide risk management programs have become more commonplace throughout the industry. However, despite this progress, the functional area of bank asset/liability management still faces rigorous requirements. Specifically, the expanded use of automated financial modeling tools that has been widely adopted by the U.S. financial institutions industry has proved extremely useful in assessing risks, ALM stress testing, model assumptions verification and model validation.

Despite these improvements, federal and state regulators are continuing to focus on the precision of each bank's asset/liability and risk management models. Institutions that have not already adopted enterprise-wide ALM and risk management programs are being forced to do so. Moreover, senior management at many high performance institutions have been considering how they can build a more risk-aware culture, in part by incorporating asset/liability and risk management considerations into performance goals and compensation decisions for key employees throughout their banks.

It is with this backdrop of intensive industry and regulatory change that our 2018 *Bank Asset/Liability Management Newsletter* ALM Compensation Survey data collection process is getting underway. As in years past, our 2018 ALM Compensation Survey will be designed to provide a profile of the salary, bonus and cash compensation practices for asset/liability management practitioners within the U.S. financial institutions industry. Our annual ALM Compensation form is included in this issue. Please complete and return the enclosed survey form no later than May 15, 2018 to Southeast Consulting, Inc. The results will be published in the July 2018 issue of *Bank Asset/Liability Management*.

Be a part of this important survey by helping us collect a representative sample of national and regional ALM compensation practices.

— Jennifer Brooke
Southeast Consulting, Inc.

Bank Asset/Liability Management

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2018 ASSET/LIABILITY MANAGEMENT (ALM) PERSONNEL COMPENSATION SURVEY
Please return by May 15, 2018

Institution ______________________________
Address ______________________________
City ____________________ State______ Zip________
E-mail address______________________________
Position Title ________________Salary______________
Bonus or incentives ______________________________
Asset size of institution (in millions) ____________________
Annual budget for ALM ______________________________
Years of asset/liability management experience ____________
Degree(s): ☐ PhD ☐ Masters ☐ Bachelors ☐ Associate ☐ Other ☐ None

Level of responsibility:

☐ ALCO chairman
☐ ALCO member
☐ A/L model operator/analyst
☐ Chief financial officer
☐ A/L risk manager
☐ Investment manager
☐ Treasurer
☐ Other__________________

Have you been affected by industry consolidation through mergers and acquisitions (position change; reassignment; address change, etc.)? Please comment.

____
____

Experience (check all items that apply):

☐ Derivative products
☐ Duration
☐ Foreign exchange transactions
☐ Gap analysis
☐ Investments
☐ Liquidity analysis
☐ Market value analysis
☐ Off-balance sheet transactions
☐ Option adjusted pricing
☐ Purchased servicing
☐ Simulation analysis
☐ Risk-based capital
☐ Credit risk_____________
☐ Other________________
☐ Other________________

ALM model used:

Currently________________
Previously________________
____
____
____

How *often* is this model used?
☐ Monthly
☐ Quarterly
☐ Semi-annually
☐ Annually
☐ Other__________

How is this model used?

Budgeting	______%
Planning	______%
ALM	______%
Other	______%
Total	100%

Primary type of institution (select only one):

☐ Bank
☐ Credit Union
☐ Savings institution
☐ Consulting firm
☐ Investment bank
☐ Regulatory agency
☐ Other______________

How would you classify your financial institution's balance sheet?
☐ Simple
☐ Typical
☐ Complex

Summary of your position responsibilities (use additional paper to continue comments):

____
____

Please send your response to *info@southeastcosulting.com* or to
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