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5 BEST PRACTICES FOR ASSET-LIABILITY MANAGEMENT

APPRAISAL OR EVALUATION? A LOOK AT THE RULES

DON'T FORGET ABOUT SUCCESSION

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5 BEST PRACTICES FOR ASSET-LIABILITY MANAGEMENT

As interest rates creep upward, federal regulators are increasing their scrutiny of banks' asset-liability management (ALM) programs. ALM models typically focus on interest rate risk — though liquidity risk is also a significant factor.

To ensure that your bank meets regulatory expectations, here are five best practices to consider.

1. GET THE BOARD INVOLVED

In today's high-risk environment, a bank's board or asset and liability committee (ALCO) needs to take a proactive approach to ALM. This approach should involve understanding the risks associated with your bank's products and activities, setting the proper tone at the top, and communicating the bank's risk tolerance throughout the organization — often by adopting an ALM or interest rate risk (IRR) policy statement.

It's important that your bank hire management personnel with expertise in managing risk effectively — and that it receive risk reports at a frequency appropriate to the bank's level of risk, but at least quarterly. These reports should contain sufficient detail to allow the board or committee to understand the underlying assumptions, identify any noncompliance with bank policies and expose weaknesses in your bank's ALM model.

2. EDUCATE THE BOARD

Directors need not be experts on ALM. But examiners expect board members to have a sufficient understanding of it to meet their oversight responsibilities and fulfill their fiduciary duties.

Banks need to provide board members with educational opportunities or include one or more outside directors

on the board who have previous experience with balance-sheet risk management. Any outside consultant should attend board meetings to discuss report results.

3. SELECT THE RIGHT MODEL

Regulators expect banks' ALM models to be adequate in light of their complexity and risk profiles. Formerly, for simple balance sheets, a maturity gap analysis may have been enough. This type of analysis measured repricing risk based on the potential "gap" in value between assets and liabilities that mature or reprice during a time period.

But more sophisticated times call for more sophisticated tools for banks whose balance sheets include underlying aspects of financial products or instruments. Typically, all balance sheets contain embedded options — such as prepayment options on both single maturity and amortizing securities or loans, withdrawal options commonly referred to as decay rates for deposits, put or call rights, interest rate caps, floors or fixed to variable or variable to fixed rate conversion rights — which demand more sophisticated simulation modeling. Evaluating the risks

associated with these options requires detailed assumptions about future interest rates, repricing assumptions, economic conditions, and customer or investor behavior.

4. EVALUATE VENDORS CAREFULLY

A number of vendors offer IRR and other ALM models that vary significantly in terms of complexity, data management and cost. When evaluating third-party models, thoroughly assess their ability to capture your institution's risks. An interagency set of frequently asked questions (FAQs) on IRR management urges banks to consider the following:

- A product's ability to model the bank's current and planned on- and off-balance-sheet products. The model should support a level of data aggregation and stratification necessary to properly measure any highly structured instruments or institution-specific products.
- The model's use of automated vs. manual procedures. The bank should consider whether the model has automated interfaces with bank systems, as well as the cost, hardware and software requirements, and necessary staff resources and expertise.
- The model's level of transparency and the adequacy and comprehensiveness of vendor model validations (independent testing to ensure that the model is performing as expected) and internal control reviews (processes in place that allow comparison of the model balance sheet with the bank's own financial reports).

Regulators also expect banks to have a reliable level of in-house knowledge of the types of IRR inherent in their balance sheets and the model's capabilities to measure such risks in the event a vendor terminates a contract or goes out of business.

5. DOCUMENT, TEST AND VALIDATE

To meet regulatory expectations, document all key assumptions incorporated into your ALM model, such as loan prepayment rates, core deposit decay rates and beta estimates (which measure how responsive management's deposit repricing is to the change in market rates). Your bank also needs to conduct periodic back-testing to compare your ALM model's projections to actual performance. This allows management to determine whether any assumptions need to be adjusted.

Don't confuse back-testing with validation. Regulators expect banks to make sure their ALM models are appropriate for their risk profiles by obtaining annual *independent* validations. The validation process involves a review, by an outside expert, of the model's logical and conceptual soundness. The expert also tests to determine whether the model's mechanics and mathematics are functioning properly.

BE PROACTIVE

It's likely that regulators will continue to scrutinize banks' ALM programs and models. To avoid examination issues, banks should be proactive in making their programs adequately reflect their risk profiles. ■

REVISIT ALM WHEN ADDING PRODUCTS OR SERVICES

Banks should review and update their ALM policies *before* adding new products or services — or adopting new strategies. Additional modeling may be required to ensure IRR risk implications are identified. Too often, banks make these changes without sufficiently evaluating the risks, only to discover that management of those risks requires additional processes or resources that reduce their return on investment.

According to the FAQs, the failure of an existing ALM model to capture risks associated with new activities will likely be viewed as a management weakness, requiring corrective action.

APPRAISAL OR EVALUATION? A LOOK AT THE RULES

When valuing real estate in connection with lending transactions, banks often hesitate to rely on evaluations in lieu of appraisals — even though they can be quicker and more cost-effective. That's usually because they fear criticism from examiners. However, the federal banking agencies' regulations permit using evaluations as part of an appropriate real estate valuation program. Here's a quick look at the rules.

WHEN TO USE EVALUATIONS

According to the federal banking regulators' *Interagency Appraisal and Evaluation Guidelines* (the "Guidelines"), evaluations are permitted for:

- Transactions valued at $250,000 or less (a proposal to increase this threshold to $400,000 is being considered),
- Business loans valued at $1 million or less, provided they don't rely on the sale of or rental income from real estate as the primary source of repayment, and
- Renewals or refinancings of existing extensions of credit, provided 1) there has been no obvious and material change that threatens the collateral's adequacy, *or* 2) no new money is advanced.

Even though the regulations allow evaluations for these types of transactions, the Guidelines state that banks should establish policies and procedures for determining when to obtain appraisals for higher risk transactions, such as those with combined loan-to-value ratios that exceed supervisory limits, atypical properties, properties outside the bank's traditional lending market or high-risk borrowers.

QUALIFICATIONS

While an appraisal requires a state-certified or licensed appraiser, the Guidelines state that those who perform evaluations should have "the appropriate appraisal or collateral valuation education, expertise and experience relevant to the type of property being valued." Examples include appraisers, real estate lending professionals, agricultural extension agents or foresters.

You can even use internal staff to perform evaluations, provided they possess the necessary training and qualifications and you take steps to maintain the independence of your real estate valuation program. Generally, that means a complete separation of the collateral valuation program from the loan production process. Maintaining such a separation may be difficult for smaller banks. According to the Guidelines, if the only person qualified to evaluate real estate collateral is another loan officer, director or bank official, the bank should ensure that person's independence by requiring him or her to abstain from any vote or approval involving loans for which they ordered, performed, or reviewed an appraisal or evaluation.

For banks lacking the resources to hire and train their own personnel to perform evaluations, the most cost-effective way to address independence issues may be to use a third party for evaluations.

> ESTABLISH CRITERIA FOR DETERMINING WHEN TO USE AN EVALUATION IN LIEU OF AN APPRAISAL AND ENSURE THE INDEPENDENCE OF THOSE ORDERING, PERFORMING AND REVIEWING THEM.

REQUIREMENTS

The Guidelines detail the minimum content requirements for an evaluation and provide guidance on evaluation development. Banks have some flexibility in selecting appropriate valuation methods, if the evaluation is consistent with safe and sound banking practices and supports the bank's credit decision. The Guidelines also emphasize the importance of understanding the property's physical condition. Typically, that means conducting a site visit and physical inspection — a drive-by estimate likely won't suffice.

Note that automated valuation models and broker price opinions (BPOs) can be useful tools but they are not, by themselves, evaluations. The Guidelines state, however, that BPOs can be used for monitoring collateral values, when appropriate.

PROGRAM REVIEW

If your bank uses or plans to use evaluations, you'll need to review your real estate valuation program to ensure it complies with the Guidelines and appraisal regulations. Among other things, establish criteria for determining when to use an evaluation in lieu of an appraisal and ensure the independence of those ordering, performing and reviewing them. In addition, monitor and evaluate those who perform them and take any other necessary steps to ensure your program meets regulatory expectations. ■

DON'T FORGET ABOUT SUCCESSION

Probably one of the last financial planning items on your list when laying out future strategies for your community bank is identifying and developing new leaders to eventually replace current ones in your organization. In the day-to-day urgency of maintaining profit margins and meeting regulatory requirements, it's all too easy to overlook the need to prepare for expected — or unexpected — loss of key management and staff. But having a succession plan in place can ensure any transitions are stable and your institution's financial trends remain positive.

SELECTING CANDIDATES

Although banks often consider external candidates to succeed the CEO, naming an internal successor may offer significant benefits. Internal candidates are embedded in the bank's corporate culture, offering the advantage of continuity. When you bring in an outsider, there's always a risk that he or she won't blend into the culture. Plus, internal candidates are familiar with the bank's operations and strategies and the current CEO's agenda.

Another advantage is that your directors — at least in theory — already know internal candidates and are familiar with their work. To ensure that's the case, invite candidates to present to the board and arrange other interactions between board members and potential successors.

TRAINING AND MENTORING

To increase your chances of promoting from within, have an active program for developing potential successors. Training, mentoring and executive coaching can help you evaluate the potential of internal candidates and help them develop the skills they need to succeed in the CEO role.

It's also important to manage candidates' expectations to avoid a mass exodus when one person is chosen as the replacement. Rather than treating the process as a competition, characterize it as a developmental opportunity for all participants and have a plan for those who aren't selected.

TRACKING EXTERNAL CANDIDATES

Despite the advantages of hiring from within, in some cases it may be necessary or desirable to consider external candidates. Perhaps you don't have a suitable internal candidate. What if your current CEO dies or becomes disabled unexpectedly, and there's no time to groom an internal successor? Or maybe you feel that your bank would benefit from bringing in "new blood."

To prepare for such contingencies, it's a good idea to track potential candidates at other banks or even in other industries, possibly with the help of a recruiting firm.

TAKING TIME

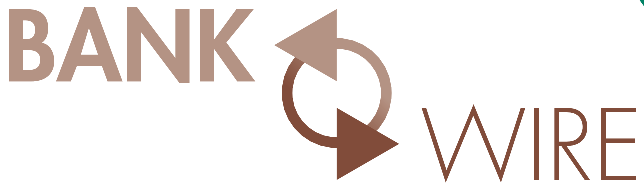
Planning should ideally begin two to five years before a potential succession event. This gives you time to define the qualifications you're looking for, draft job descriptions, and evaluate internal and external candidates.

It also gives you time to develop internal candidates. And you can formulate a retention plan for those who aren't selected.

> TO INCREASE YOUR CHANCES OF PROMOTING FROM WITHIN, HAVE AN ACTIVE PROGRAM FOR DEVELOPING POTENTIAL SUCCESSORS.

UPDATING AND ADJUSTING

Of course, any plan depends on a particular set of circumstances, both in terms of personnel and business practices, which may shift and change over time. So it's important to schedule regular updates to ensure your plan remains relevant in light of the bank's current situation. Remember to create a strong blueprint and you'll ensure your bank stays at the top of its game for years to come. ■



WATCH OUT FOR THE TCPA

The Telephone Consumer Protection Act (TCPA) prohibits most calls or texts to consumers' cell phones, without prior express consent, using an automatic telephone dialing system, also known as an "autodialer." The definition of "autodialer" is broad, and somewhat unclear. But according to the FCC, it includes equipment that has the "potential ability" to function as an autodialer even if it's used to make manual calls.

Penalties for violating the TCPA are harsh. It's important to evaluate your consumer communication technology to ensure that you comply. ■

GUIDANCE PERMITS HIGH LTV LENDING PROGRAMS IN DISTRESSED COMMUNITIES

In August, the OCC issued Bulletin 2017-28, which permits national banks and federal savings associations to establish programs for originating higher loan-to-value (LTV) loans in communities targeted for revitalization. Current guidance generally limits LTV ratios for owner-occupied residential loans to 90% or less, unless appropriate credit enhancements, such as mortgage insurance or readily marketable collateral, exist. But banks can make exceptions in individual cases under certain conditions.

The new guidance permits banks to offer mortgage loans with LTV ratios that exceed 100%, without credit enhancements, as part of a program of lending in distressed communities. An eligible program loan is a permanent first-lien mortgage — with an original loan balance of $200,000 or less — used to finance the purchase, or purchase and rehabilitation, of an owner-occupied residential property in an eligible community. Eligible communities are those that have been officially targeted for revitalization by a federal, state or municipal governmental entity or agency — or by a government-designated entity, such as a land bank. Home equity loans, lines of credit and refinancing loans are not eligible.

The Bulletin also outlines program-related policies and procedures banks are expected to adopt (including certain disclosures to borrowers). In addition, it requires banks to notify the OCC in writing at least 30 days before they begin or substantially change their program, and provides for OCC evaluation of individual banks' programs. The OCC will evaluate, at least annually, the overall success of these programs and may rescind the bulletin if the programs aren't contributing to community revitalization or if risk isn't adequately controlled. ■

DIGITAL IS NO LONGER OPTIONAL

According to the FIS 2017 Performance Against Customer Expectations (PACE) Report, small and midsize businesses (SMBs) are embracing mobile banking and other digital solutions at a faster pace than consumers — and they're willing to switch banks to obtain the services they desire.

This gives banks with digital solutions an edge on the competition. It also provides other banks with an opportunity to retain their SMB customers by boosting their digital offerings. ■

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