



## Community Bank Views – A Banker’s to-do...

January 31, 2019

With the new year brings the opportunity for banking professionals to elevate their game. Rather than continuing to focus only on what needs done right now – the daily grind per se – management should begin the process of integrating 2019’s opportunities as related to the bank’s strategic goals into deliverables. Thus, creating this year’s to-do list. Understanding that strategic goals are normally centered around profitability and risk, this month’s article addresses those tasks that can materially impact an institution’s overall safety & soundness.

### Strategy Implementation & Alignment

Consistent with best practices, the new year’s strategic goals were likely the foundation for the bank’s 2019 budgeting process. Because these goals are often developed at a high level, management is now tasked to create a series of tactical goals – all designed to achieve the bank’s strategic goals. Through the bank’s Asset/Liability Committee, ALCO has the responsibility to effectively communicate the tactical assignments to each respective line of business (LOB). Understanding that most LOBs tend to operate in a silo-like function, aligning action with expectations challenges even the most seasoned ALCOs. In addition to alignment, clarity of message at all levels of management is critical to hitting budgeted earnings. Make sure key players not only understand the bank’s strategic objectives, but how their contributions feed into the bank’s success. Alignment + clarity of message + accountability = strategic success!

### Balance Sheet Management

A change in the business cycle is fast approaching. As such, Fed policy is beginning to shift from restrictive to neutral to eventually accommodative. Based on current Fed speak, 2019 could be the year of neutrality. Taking it one step further, some expect the Fed to become accommodative in policy as early as 2020, if not before. Depending on your institution’s current interest rate risk profile, management may want to begin the process of repositioning the balance sheet for lower interest rates. Asset sensitive institutions may want to consider the following balance sheet strategies:

*Continue to originate loans funded with core deposits and/or bond portfolio run-off. As the change in business cycle nears, margin will be primarily driven by the earning-asset side of the balance sheet. As such, limit optionality on the asset side in preparation for lower interest rates. Continue efforts to remain fully invested by deploying excess cash. Selectively extend asset duration taking advantage of the still positively-sloped yield curve while protecting earnings from falling rates. When redeploying earning assets, shifting duration out of the bond portfolio into the loan portfolio will likely improve margin. On the funding side, keep term funding short (if not overnight) as the balance sheet’s current IRR profile may not warrant the need to lock in longer-term fix rate funding. If offering retail CD Specials, offer terms consistent with management’s expected downward shift in the yield curve. Keeping CD Special terms under 30 months would be considered reasonable based on current economic forecasts.*

Although the above-listed actionable items are consistent with those normally used by positively-gapped institutions, any repositioning strategies deployed by management should be based on the institution’s unique interest rate and liquidity risk profile. The takeaway here is that if you haven’t already, start the process of protecting earnings and capital from lower interest rates. Understanding that ALCO plays a key role in managing the balance sheet, reach out to your ALM team as this issue is in their wheelhouse.



## Model Management

While decision making at the community bank level relies on management's experience, reason and careful deliberation, analysis derived from the use of financial models play an important role in proper decisioning. Models turn information into analysis which then is used to make better decisions. While financial institutions use models in a wide range of applications, today's focus is on the Asset/Liability Simulation model – the tool that best measures the possible adverse effects on earnings and equity precipitated by movements in interest rates. Recent shifts in the treasury yield curve have elevated the importance of an effective ALM program. As such, management should consider, not just as best practices but as regulatory expectations, incorporating the following items into this year's deliverables:

- Key Assumption Review – with primary focus on non-maturity deposit and prepayment assumptions. Institutions should strive to use assumptions that reflect the institution's profile and activities and generally avoid reliance on industry estimates or model defaults.
- Sensitivity Testing – Sensitivity analysis tests the model's parameters without relating those changes to an underlying event or real-world outcome. Sensitivity analysis should focus on the most influential assumptions to identify key variables whose volatility may significantly affect interest rate risk (IRR) exposure.
- Stress Testing – Stress analysis uses the model to predict a possible future outcome given an event or series of events. Stress analysis should consist of scenarios that are severe but plausible in light of the existing level of rates and the interest rate cycle. Stress scenarios could include, but are not limited to, the following:
  - instantaneous and significant changes in the level of rates,
  - substantial changes in rates over time,
  - changes in the relationship between key rates,
  - changes in the slope and shape of the yield curve, and
  - key assumption/sensitivity testing with primary focus on prepayment speeds and NMD decay & lag/betas.

Commonly performed stress tests include a combination of scenarios chosen from a matrix of sensitivity tests and rate scenarios, including the lengthening/shortening of decay rates, the shifting in lag/beta assumptions, the increase/decrease of prepayment speeds and the introduction of a credit event (deterioration in credit).

- Back Testing – Back testing analysis allows management to compare model results to actual behavior in order to form an opinion as to whether the simulation model is predicting reasonable future earnings and equity balances. Back-testing is an integral part of a comprehensive asset liability management and IRR review process. When performed correctly, back-testing analysis can either confirm that the data and the assumptions are correctly forecasting present values and earnings or highlight areas that require attention. Back testing is never one and done. It should be continuous and ongoing.
- Statement of Certification – If you haven't already, ask your ALM provider for the most current copy of the model's Statement of Certification confirming that a qualified 3<sup>rd</sup> party has performed an independent, external certification verifying that the model's underlying methodologies and mathematics are accurate, in-line with industry standards and consistent with the vendor documentation.
- Validation – This is a biggie as it can be costly, particularly for smaller institutions. On the other hand, using non-validated models to manage risks to the institution is potentially an unsafe and unsound practice – using regulatory speak. Even when the risk is not particularly material, the reliance on non-validated models can be costly business practice. The assessment of the costs and benefits of model validations is subjective and context-driven and is the responsibility of bank management. To promote a sound process, regulators (*OCC*) provided a summary list of expectations, and suggest that formal policies and bank practices address the following:
  - *Decision makers understand the meaning and limitation of a model's results. Where the models are too abstract for non-specialists to understand the underlying theory, the bank must have a model reporting system in place that transforms the model's outputs into useful decision-making information without disguising the model's inevitable limitations.*



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- *The bank should demonstrate a reasonable effort to audit the information inputs to the model. Input errors should be addressed in a timely manner.*
- *The seniority of the management overseeing the modeling process should be commensurate with the materiality of the risk from the line of business in process.*
- *To the extent feasible, model audits must be independent from model construction.*
- *Responsibilities for the various elements of the model-audit process must be clearly defined.*
- *Modeling software should be subject to change control procedures, so that developers and users do not have the ability to change code without review and approval by an independent party.*

This laundry-list of deliverables may seem exhaustive. As such, seek guidance from your ALM team. They'll have the skillset necessary to break down the list into manageable tasks.

Policy & Policy Limit Review – Management should ensure that the structure of its business and level of risk it assumes are effectively managed and that appropriate policies are established to control and limit risk. Policy limits should be consistent with management's overall approach to measuring risk and should be based on capital levels, earnings, performance and risk tolerance.

Vendor Management – Revisit the ROI (return on investment) as related to your institution's key vendor relationships. As banker's, we understand their need to be profitable. As an aligned business partner, we want our vendors to stay in business. While we expect them to make money, it's important that we're getting a reasonable rate of return on all dollars spent. Don't be afraid to shop around – it's always good to have options especially going into contract renegotiations. We expect vendor relationships to be mutually beneficial – not hostage situations.

If you would like to further discuss these concepts, please reach out to your CMG representative.

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