

## Guidance consultation

# Senior Asset and Liability Management Committee Practices

## Proposed Dear DEO letter

November 2010



## ASSET AND LIABILITY MANAGEMENT

Dear CEO,

I am writing to set out the 'good practices' we have observed during our asset and liability management (ALM) examinations over the last year.<sup>1</sup> I also want to take this opportunity to expand on these observed practices and set out some suggestions which may make your ALM functions more effective. Smaller firms should consider the content of this letter proportionately and in the context of their own business model.

Our observations relate to the senior committee charged with the responsibility of managing ALM issues. This could be the executive board management committee itself (EXCO) or a sub-committee of EXCO.

Four key themes emerged from our work in this area:

1. The role of the senior ALM committee. We draw out the core purpose of this committee noting that, in many firms, the function is also responsible for designing and implementing a funds transfer pricing mechanism.
2. The composition and authority of the senior ALM committee. The most effective senior ALM committees appear to be those that are chaired routinely by the CEO.

---

<sup>1</sup> Standards for a governing body's oversight of liquidity risk tolerance, which we consider is closely related to asset liability management, are contained in BIPRU 12.3 and the narrow topic of interest rate risk management is covered in BIPRU 2.3. Although the rules are expressed in a high level way and do not set out specific practices for ALM committees to follow, we encourage firms to follow the good practices set out in this letter. These do relate broadly to the rules and may be seen as indicators that a firm is in compliance. We also think that it is helpful to bring together our observations on ALM since our prudential rules do not treat this topic as a discrete risk. Our views are based on a number of in depth reviews of treasury functions and associated risks as part of introducing the new liquidity regime, as well as our on-going supervisory assessments and reviews. This work covered a wide range of firms - including both large and small banks and building societies, overseas banks operating in the UK, and some larger investment firms. As part of this work, we have attended as an observer a number of senior ALM committees, as described more fully in this letter, and received senior ALM committee minutes and papers from a wide range of firms.

3. The forward-looking nature of, and decisions made by, the senior ALM committee. Our reviews highlight a focus on monitoring and commenting on the past rather than proactive management of the future.
4. The degree of challenge observed at the senior ALM committee. We have found this hard to identify: we would expect the minutes of ALM meetings to give non-attendees insight into the discussion and challenge which took place.

We are also providing supplementary information as follows:

- Appendix 1 sets out our more detailed observations on the issues considered by the senior ALM committee, with a particular focus on ALM management information packs and the development of stress-testing and contingency funding plans.
- Appendix 2 sets out some key observations from attending, as an observer, a number of senior ALM committee meetings.
- Appendix 3 offers points that you may want to consider in relation to the senior ALM committee meetings.

### 1. The role of the senior ALM Committee

ALM is a key management function that spans the entire legal entity and group, as appropriate. The exact scope of ALM can vary, for example oversight for non-traded market (interest) risk in the banking book might be the responsibility a separate market risk committee, sitting alongside the senior ALM committee. We also appreciate that the senior ALM committee may additionally be charged with the responsibility of monitoring capital and risk-weighted assets. But this letter deliberately does not comment on the ALM function in relation to capital, risk-weighted assets, traded market risk or credit risk.

The ALM function clearly does focus on the entire balance sheet. Its core purpose, from our experience, is:

- to ensure that individual business lines are aligned in terms of the firm's overall objectives and proactively controlled, with regard to the prudential risks under the ALM's control (liquidity, and funding risk and interest rate risk in the banking book);
- to ensure that all ALM risks remain within the risk appetite set by the governing body; and
- to evaluate and assess the impact of other potential driver of earnings volatility, such as competitive pressures or non-interest rate related changes to market conditions.

In many firms the ALM function is responsible for designing and implementing an appropriate funds transfer pricing mechanism. Effective senior ALM committees regularly review this mechanism to ensure all business areas are aligned with and incentivised according to the firm's strategic objectives and risk appetite.

### 2. The composition and authority of the senior ALM committee

The senior ALM committee has an extremely significant governance role in implementing and controlling the risk appetite established by the governing body and the funds transfer pricing mechanism in entirety, and across all the separate business lines. Often this requires the senior ALM committee to balance objectives and allocate 'resources' across competing business lines.

We observe that the most effective senior ALM committees are typically those that are formal sub-committees of EXCO and routinely chaired by the CEO. In the main we observe that the membership of good senior ALM committees includes all the business line heads, together with the Chief Finance Officer, Group Treasurer, Chief Risk Officer, Head of Market Risk and Head of ALM, and are often also attended by the Head of Internal Audit and the Chief Economist. This ensures that the senior ALM committee is appropriately empowered, that all business lines and control functions are represented, and that they acknowledge the authority of the senior ALM committee. Some smaller firms may deem it appropriate for relevant non-executive directors to attend the senior ALM committee meeting on a regular basis.

### **3 The forward-looking nature of, and decisions made by, the senior ALM committee**

Our reviews highlight that the senior ALM committee is often unduly preoccupied with monitoring and commenting on the past rather than on proactive management of the future. We accept that the senior ALM committee needs to undertake a degree of monitoring to ensure the risk appetite set by the governing body is complied with and provide risk updates to EXCO and the wider governing body. However, good senior ALM committees (appear to) focus more on the asset and liability impact of the future plans and strategy at the entity and, where appropriate, group level.

We have observed the senior ALM committees of the largest UK banks, at group, subsidiary, and regional level, as well as those of a number of building societies and the UK subsidiaries of international groups. We have also reviewed the senior ALM committee minutes and papers from a wide range of firms. A common theme is that senior ALM committees appear to ‘observe’ the ALM risks rather than actually taking decisions to manage them or escalating issues to EXCO.

We observe that deliberations are often more effective if EXCO members on the senior ALM committee refrain from suggesting decisions until issues have been fully articulated and debated. In many cases the senior ALM committee usefully considers recommendations from a tactical sub-committee that excludes the CEO and other EXCO members.

### **4 The degree of challenge observed at the senior ALM committee**

Although we observed some degree of challenge at a number of committee meetings, challenge was absent at others. And where challenge was observed, we were subsequently unable to evidence this in the minutes of these meetings. When minutes are presented as evidence of challenge, it is often difficult to substantiate the degree of challenge from these minutes. The minutes should give non-attendees, including non-executive directors, an insight into the discussion and the extent of any challenge which took place and not merely list the action points.

### **Cross- reference to FSA rules and guidance**

The FSA has set out detailed risk management requirements in relation to liquidity and funding risk in BIPRU 12.3 and 12.4. Other areas discussed in this letter are covered under BIPRU 2.3 (interest rate risk) and SYSC (Senior Management Arrangements, Systems and controls).

Yours sincerely

Jon Pain

Managing Director, Supervision

### Appendix 1: The issues considered by the senior ALM committee

The following represents guidelines and observations around the issues covered by the senior ALM committee alongside specific observations drawn from our review of a wide range of firms' senior ALM committee packs.

Senior ALM Committees typically cover at least the following issues:

1. Asset and liability impacts of current operating plans, and market update
2. Liquidity and funding risk
3. Interest rate risk in the banking book (IRRBB) and other drivers of net interest income sensitivity
  - o Non-traded market interest rate risk in the banking book including market index bases risks
  - o Structural non-discretionary interest rate risk in the banking book
  - o Other potential non-interest rate drivers of income volatility
4. Funds transfer pricing mechanism
5. Structural foreign exchange risk
6. Liquidity stress testing
7. Contingency funding plans

#### 1. Asset and liability impacts of current operating plans and market update

Good ALM packs focus on the corporate plan over the corporate planning horizon, analysing the plan by asset and liability mix, currency, growth and by legacy back book and front book yield and margin. Variations between actual and plan are sufficiently explained. Good packs focus on the key risk ratios for liquidity and structural funding so that the senior ALM committee can assess whether the combined plan of all the business lines will result in the entity remaining within the risk appetite set by the governing body.

Good packs present the firm's consensus economic outlook, with the impact on ALM issues reassessed if the economic fundamentals change significantly. Good packs cross reference the firm's own economic outlook to the base case used for planning purposes (the corporate plan) and use stress scenarios to assess the ALM sensitivities and vulnerabilities to changing economic conditions on both the back book and planned future business. Some senior ALM committees have developed economic triggers, which invoke early or more frequent committee meetings or even act as 'soft' early warning indicators for the firm's contingency funding plan.

#### 2. Liquidity and funding risk

Good firms focus on both a legal entity and where appropriate a group view ensuring that potential trapped liquidity or large exposure restrictions are correctly assessed. Many senior ALM committees focus on the

consolidated accounting group which often in practice does not reflect cross border liquidity flows. A good senior ALM committee should analyse 'surplus' liquidity potentially trapped in foreign branches, when considering a solo legal entity view.

Good packs show their liquidity and structural funding metrics by material currency; we noted that in poorer packs material currency views were often absent. Good packs will also forecast the metrics from a rolling update to the corporate plan by currency and business line.

Most firms, where applicable, present the future wholesale refinancing risk showing the maturity profile of secured and unsecured sources. Some firms overlay their competitors' (publically available) maturity profile to assess potential refinancing risk stress points in the market and help the senior ALM committee assess whether the firm is exposed to market-wide refinancing risk. Good packs also seek to identify any funding concentrations.

Our observations around short term liquidity metrics are that in many cases the metrics do not cover all liquidity risks and hence do not ensure adherence with the risk appetite established by the governing body (through limits established across all risk drivers and set so as to ensure that if all metrics were on limit the entity would still be inside the risk appetite). It is logical that the senior ALM committee ensures that the definition of liquid assets used is compatible with the risk appetite set by the governing body.

Most senior ALM committees are presented with a liquidity maturity mis-match ladder, but these often reflect behavioural assumptions without the underlying assumptions or sensitivities to these assumptions being set out, explained or appreciated. Good senior ALM committee papers present both a contractual mis-match ladder and one based upon behavioural assumptions together with a description of the behavioural assumptions made and the key sensitivities.

Good senior ALM committees regularly assess the viability of the medium-term funding plan and the impact on earnings (NII), under both a base case consistent with the firm's economic outlook and under stressed economic scenarios. Firms should assess whether the plan is consistent with economic expectations and any potential rating agency actions that could result under a stressed economic scenario.

### 3. Interest Rate Risk in the Banking Book (IRRBB) and other drivers of net interest income (NII) sensitivity

Good firms produce separate analyses of interest rate risk using EVE, VaR, NII sensitivity, basis risks and scenario stress testing and go wider than IRRBB in assessing the drivers of earnings volatility. Non-traded 'market' interest rate risk is often analysed separately and considered market risk by many firms, an approach we endorse and in these circumstances this risk can sit outside the scope of the senior ALM committee.

Good packs also set out the extent and nature of interest rate behavioural assumptions used to determine the level of non-traded market interest rate risk and the sensitivity of the position reported to these behavioural assumptions.

Non-discretionary structural IRRBB is often assessed using some form of earnings impact analysis such as NII or EVE using scenarios that envisage parallel shifts and ramps in interest rates. However in most cases the NII/EVE analysis is performed on the entire banking book including the non-traded market interest rate risk leading to a potential 'clouding' of the true underlying non-discretionary structural IRRBB position. The most effective senior ALM committees assess NII/EVE on the non-discretionary IRRBB only (i.e. excluding

discretionary non-traded market risk) and additionally explore other non-interest rate risk scenarios to identify the non-interest rate drivers of earnings (NII) volatility, such as changes in the competitive environment.

The FSA's forthcoming discussion paper on IRRBB will expand further on this area.

Good packs provide the right level of granularity and assumptions required to invite challenge and discussion. As IRRBB and wider earnings volatility is difficult to capture in one measure, the governing body would set 'soft' limits against each measure for the senior ALM committee to measure against and present sensitivity analysis around the key non interest rate assumptions inherent in the NII/EVE models. Our observations show that most firms were not sufficiently aware of the inherent structural earnings volatility to which they were exposed such as margin compression arising from a low rate environment or significant changes in the competitive landscape.

Good packs also produce separate scenario analysis on prepayment risk, pipeline and attrition risks and factor in other potential drivers of earnings volatility.

#### 4. Funds transfer pricing mechanism

Good senior ALM committees also seek to ensure that the funds transfer pricing mechanism (FTP) is appropriate, and act as the arbitrator between business lines in designing and implementing FTP. Good senior ALM committee packs set out the key highlights of the FTP process and the basis and results of the calculation. Please refer to our recent 'Dear Treasurer' letter on funds transfer pricing issued on 5th July 2010.

#### 5. Structural foreign exchange risk

Very few firms provide analysis on the foreign exchange sensitivity to net investment in foreign operations and currency revenue flows.

#### 6. Liquidity stress testing

Good senior ALM committees have developed reverse stress testing scenarios, in which the business model becomes unviable. The scenario(s) seek to explore the circumstances that create successive years of negative earnings (NII) and second round effects on funding. Some firms also explore the circumstances which exhaust their liquidity resources and management actions (reverse liquidity stress testing). The most advanced senior ALM committees evaluate and advise their governing bodies as to whether failure (reverse) scenarios are acceptably remote, and present these to EXCO and the wider governing body to assess the remoteness of failure scenarios in relation to the governing body's articulated liquidity risk tolerance. The most sophisticated packs also present a set of liquidity stress scenarios representing scenarios more severe than firm's risk appetite but less severe than 'failure' to allow the senior ALM committee to identify vulnerabilities under various scenarios.

### 7. Contingency Funding Plans

Good packs present the contingency funding plan (CFP) as more than just an operational business contingency plan, assessing the capacity of the plan and factoring these assessments into reverse liquidity stress testing. The senior ALM committee will probably want to ensure that the CFP is operationally tested as far as practically possible and to make sure that the early warning indicators are up to date and relevant to the information provided in the pack. The senior ALM committee will probably want to ensure that any management action included in the plan is realistic and could be undertaken under the scenario being considered.



## Appendix 2: Key observations from attending senior ALM committees (referred to as ALCO below).

**The CEO or another EXCO member of ALCO raises the question as to what key liquidity or funding metrics are indicating.** If EXCO members have to ask at each ALCO then the metric is not working. Assumptions and definition could be clearer. Maybe there is a better way to display the information.

**ALCO members could not understand the EVE and NII results.** This shows a lack of understanding as to the methodology and assumptions. New members could be trained on the methodology.

**An economist's view can take up considerable time at an ALCO meeting and may be unconnected to the rest of the ALCO discussion.** The economist's view could be drawn out from the corporate plan for margin and liquidity purposes, benchmarked against consensus and back tested.

**A meeting before the ALCO meeting had reached a different view to the one at ALCO, and one or other view is overruled.** It is important that business lines and control functions are working from the same strategy.

**Most of the meeting's time was spent acknowledging that the firm had remained compliant with its limits.** Risk and return cannot be managed by looking in the rear view mirror. The monitoring of limits could be delegated to a sub-committee or a risk function and the senior ALM committee could then focus on planned future actions.

**Recommendations were accepted without challenge.** Members could be given the pros and cons of each recommendation. Minutes would show that there was a shared discussion on each proposal.

**Agenda so large that it was managed by exception.** Little time was spent on key risk factors or measures. Firms could think about having sub-committees for certain issues or perhaps changing the terms of reference of ALCO.

## Appendix 3: Aide memoire for CEO to review the effectiveness of the senior ALM committee

- Did members note the current position against limits and take action if forecast predicts deterioration?
- Did members agree that all liquidity and funding risks are covered?
- Did members agree that all IRRBB risks are covered?
- Did members acknowledge that the **forecast** indicators are within risk appetite?
- Did absentees nominate a subordinate?
- Did any of the members have trouble interpreting the standard MI pack?
- Did the members consider whether the economist's forecasts mean that a revision to the corporate plan is necessary?
- Does product pricing and mix need to change as a consequence?
- Does under utilisation of limits tell us anything?
- Was the committee comfortable with any possible contradiction between EVE and NII?
- Do members agree that the high impact scenarios are acceptably remote?
- Do **projected** performance ratios meet the Board objectives?
- Are **projected** liquidity and funding metrics within governing body risk appetite?
- Does FTP incentivising business lines in a manner consistent with the firm's objectives and risk appetite.