BUREAU OF BANKING
Department of Professional and Financial Regulation
State of Maine
March 26, 1993

BULLETIN #55 ASSET/LIABILITY MANAGEMENT

The Bureau of Banking has become increasingly concerned about the asset/liability management ("ALM") practices at supervised institutions during this past year. Recent examinations have revealed that many institutions increased exposure to interest rate risk. The reasons for increased exposure appear largely due to a lengthening of bond portfolios to take advantage of a historically steep yield curve, particularly in view of weak loan demand, and increased potential sensitivity of traditionally non-interest sensitive deposit liabilities, such as regular savings and NOW accounts.

Many supervised institutions continue to rely exclusively on gap analysis for assessing and managing their level of interest rate risk. The Bureau recognizes that this traditional gap analysis is a flawed analytical tool as it does not adequately measure and/or distinguish basis risk, repricing velocity, and balance sheet momentum with respect to earning assets and funding liabilities. The current view among financial managers is that models simulating the impact of rate changes to net interest income and/or the market value of portfolio equity are a more accurate and sophisticated method of measuring and managing an institution's interest rate risk.

It should also be noted that the Federal Deposit Insurance Corporation Improvement Act of 1991 directs the federal banking agencies to amend risk-based capital rules to account for interest rate risk by 6/19/93. Their preliminary proposal includes a duration-based measurement, which is a substantially different approach than traditional gap analysis.

The Bureau's on-site examinations also reveal that policies and practices of many supervised institutions, with respect to ALM management, could be improved. Policies tend to be overly general and do not create a framework of accountability and responsibility for managing the institution's balance sheet for liquidity and interest rate risk. Therefore, the Bureau requests that all supervised financial institutions review their ALM polices, practices, and management information systems for possible improvement. At a minimum, a good ALM policy should contain the following:

1. Provide for the establishment of an Asset/Liability Committee. Define who will be the members, what its responsibilities will be, how often it will

meet, how it will obtain input from the board of directors, and how its results will be reported to the board of directors;

2. Provide for the establishment of a suitable management information system to measure and assess liquidity, balance sheet structure, and interest rate risk. Reports may include, but not necessarily be limited to, margin analysis, liquidity needs and sources of funds to meet those needs, interest rate risk simulations, traditional gap reports, historical interest rate risk comparisons, economic/market conditions summary, and exceptions to policy guidelines.
3. Provide for periodic review of the institution's funding structure (deposits and borrowings). Include the volume and trend of the various types of funding liabilities, maturity distribution, rates paid, market competition, potentially volatile funds, and any other pertinent information;
4. Establish general parameters for asset diversification by type, maturity, etc. in conjunction with the financial institution's loan and investment policies;
5. Establish standards of liquidity risk using one or more measurements. Typically, the regulators measure liquidity risk using the loan/assets ratio, potentially volatile liability dependence ratio, and the traditional regulatory liquidity ratio (short-term and marketable assets to deposits and short-term liabilities). Financial institutions, however, are encouraged to develop alternative measures that may be more meaningful and/or appropriate;
6. Establish standards for interest rate risk. Historically, banks and regulators have used a benchmark of +/- 5% gap to assets and RSA/RSL of 90%-110%. Institutions, however, are encouraged to establish alternative measures based on alternative simulation models. For instance, standards may be established based on changes to net interest income, net income, or the market value of portfolio equity;
7. Review of alternative sources of funds; establishment of bank lines and test their use periodically;
8. Provide for tax planning.

Since market interest rates are at historical lows, the yield curve is very positively sloped, and there are new regulations forthcoming from the federal banking agencies, the Bureau of Banking believes it is important for all institutions to reassess their ALM program. Considering that the federal banking agencies are scheduled to issue risk-based capital rules with an interest rate risk component by 6/19/93, particular emphasis should be placed on reviewing and improving management information systems with respect to ALM.

It is acknowledged that some institutions may chose to hire consultants to assist in developing an effective ALM program and managing liquidity and interest rate risk. The Bureau of Banking believes that employing qualified consultants with respect to ALM can be beneficial as long as the board of directors and senior management develop sufficient knowledge to critically evaluate advice and recommendations of their consultants. It is important, however, that institutions chose their ALM consultant carefully. Many broker/dealers are now representing themselves as competent ALM advisors as a marketing tool and offer ALM models as "soft dollar" incentives to open accounts and execute trades through their firms. Financial institutions should not engage ALM advisors who are fully or partially dependent on some volume, incentive, and/or transaction-based compensation. In order to avoid conflicts of interest, institutions should only hire ALM consultants or advisors who provide service for fees and who have no financial interest in the implementation of recommended strategies.

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