FINASTRA

Asset and Liability Management

The nerve center of modern banks

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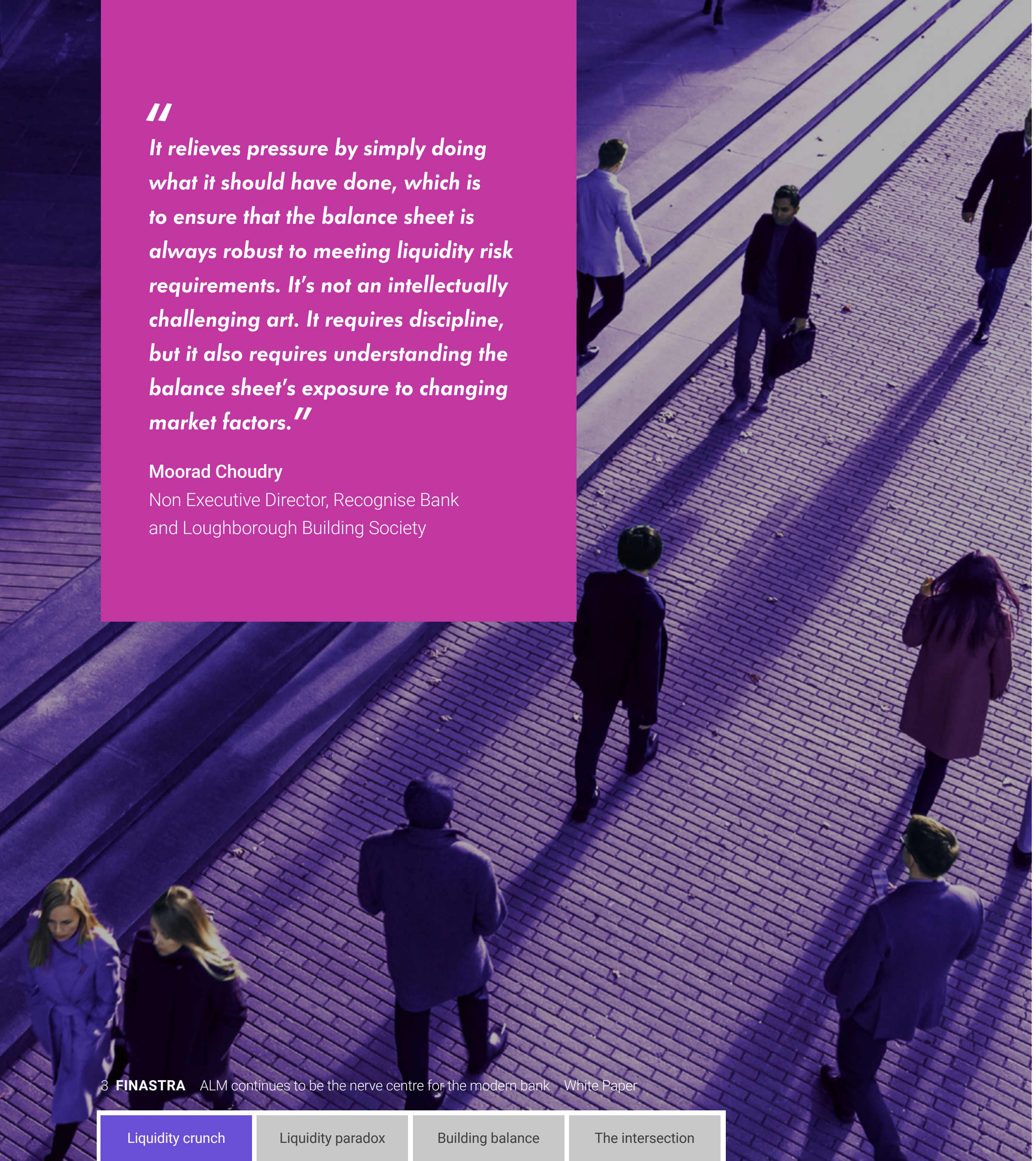

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Moorad Choudry
Non Executive Director, Recognise Bank and Loughborough Building Society

Liquidity crunch hits US banks

After being awash with liquidity over the last decade, 2023 has been a tumultuous year for banks. Banking failures on both sides of the Atlantic have brought renewed focus to Asset & Liability Management, bringing an often-overlooked discipline once again into the spotlight.

Bank runs, such as those that occurred at Silicon Valley Bank (SVB), are almost as old as fractional reserve banking itself. Management of liquidity risk can be considered the original risk in banking, pre-dating interest rate risk by hundreds of years. However, in an era where focus is often drawn to more glamorous areas in a bank, the collapse of SVB re-emphasised that effective liquidity and interest rate risk are at the heart of the banking business model.

Addressing to the collapse of Silicon Valley Bank **Moorad Choudry** , Non Executive Director at Recognise Bank and Loughborough Building Society, lays the blame for the failure on poor management and lack of ALM discipline. He argues that "By simply doing what it should have done, which is to ensure that the balance sheet is always robust to meeting liquidity risk requirements. It's not an intellectually challenging art. It requires discipline, but it also requires understanding the balance sheet's exposure to changing market factors."

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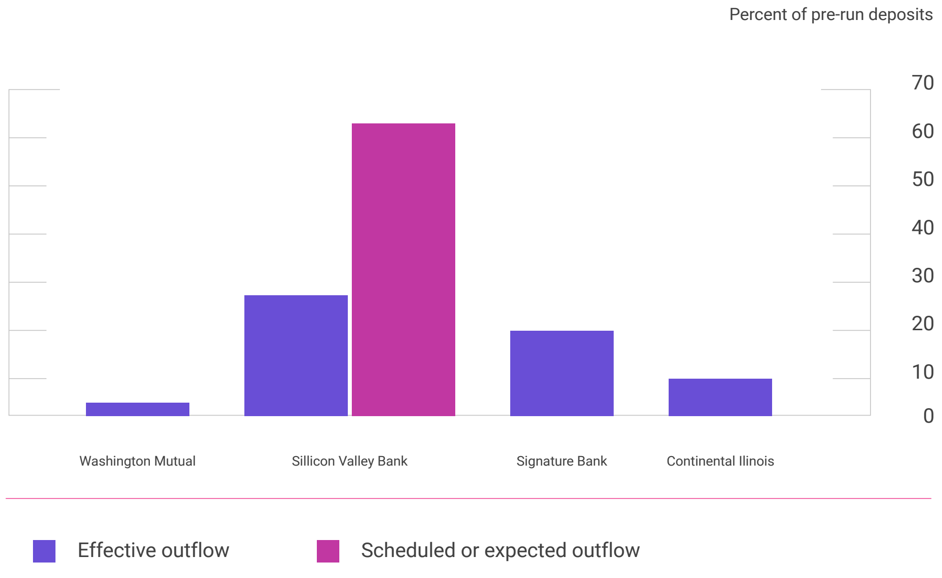
The liquidity paradox

Paradoxically, one of the factors that led to the failure of Silicon Valley Bank was excess liquidity, what **Austin Elsey** Chief Credit Officer at FMS Bank calls an anti-stress event. He describes it as "when the financial institution finds itself dealing with a liquidity influx that's pumped into the system. Naturally, as the cash sits on the balance sheet, it creates concern about how they could leverage and get a margin of return to maximize that profitability." He added "Having extra liquidity is a good thing, but if we didn't prepare for that and properly plan for exiting that scenario, that's where banks start to feel that pressure."

Liquidity was pumped into the system during the COVID crisis as financial authorities responded to the exogenous shock through large scale asset purchases. SVB's liability holders, Silicon Valley tech startups, also found themselves awash with increased COVID related IT spend which ended up on the SVB balance sheet.

Since the 2008 crisis the high cost of funding in senior unsecured markets have seen banks increasingly turn to the deposit base as a low-cost source of funding. Deposits also receive favourable regulatory treatment, where it is regarded as a high-quality funding source.

Peak bank run single day withdrawals taken from Financial Stability Report May 2023



However, surges in liquidity flows from the depositor base are expected to increase in the era of digitisation and open banking. At the apex of the SVB crisis, customers withdrew a staggering $42b in a single day March 9th, which amounted to a quarter of the bank's deposits. The following day depositors withdrew 20% of total deposits from Signature Bank. Contrast this silent gutting of the balance sheet by SVB and Signature Bank depositors with the alarming scenes of Northern Rock deposit holders, a UK bank that collapsed during the financial crisis of 2007. Despite the panic the maximum deposit outflow at Northern Rock on a single day was around 5%, nothing like the scale we witnessed during the bank runs of 2023.

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Moorad Choudry
Non Executive Director, Recognise Bank and Loughborough Building Society

Building a robust balance sheet to withstand economic tailwinds

A robust and profitable balance sheet is the aim of ALM, the ability to withstand different stresses to both the economic environment and customers' reactions to it. Mr Choudry comments "In a bank's effort to be conservative, it invests in ten-year treasuries, ten-year mortgage bonds, and other securities", which he said is understandable from a credit risk point of view. "However, banks should also recognize that it extends the rate of risk." The role of ALM is to uncover risks, which in the case of SVB was the susceptibility of the balance sheet to interest rate rises. These type of stress tests are also increasingly embodied in the regulatory requirements, including Interest Rate Risk on the Banking Book (IRRBB) to which SVB, with a sizeable balance sheet of over $200b, was infamously exempt.

Addressing the Mr Choudry remarks "I think we are getting into a little more sophisticated model of understanding what that true investment curve looks like. Is there a prepayment risk on the backside? Are we going to be exposed to losing the funds quickly in the rates-down if this rate environment shifts really quickly?".

As the interest rate crisis at SVB evolved into a liquidity crisis, Mr Choudry highlighted the impact of behavioural risk commenting that "average contractual tenure of their funding was very short. While that's not necessarily a bad thing, an ALM process should prepare the bank better when there are sudden changes in market factors."

The fact that ALM is at the locus of many different areas within the bank – risk, regulatory, finance, hedging – creates a lot of demands on the Asset and Liability Committee (ALCO) and it their job to balance these forces. **Mark Benaharan**, SVP for Liquidity and Capital Stress Testing Risk Management at New York Community Bank comments "I think a lot of times I hear ALM departments saying there are different sides of the coin and different sides of how we do things. I think whether you come from a finance background or quantitative background or trading background, or management background, those are all the same sides of the coin. They are complementary to each other."

Mr Benaharan adds "What can definitely help management is they take a multiple-view approach to ALM, which is inclusive of the different dimensions of risks and finance within the organization."

For Mr. Choudry, addressing stakeholder concerns under the oversight of the board is key in a well-functioning ALCO.

He remarks "The ultimate balance sheet as a mixture of loan and deposit products that most efficiently meet the needs of different stakeholders that move in different directions—the regulator wants lots of capital and liquidity that drag on the balance sheet, which opposes what the shareholder wants. Meanwhile, the customer wants good service and good interest rates. ALCO's role is critical in this three-dimensional optimization if banks wish to move away from the traditional approach. Setting budgets and targets need to be bank-wide and overseen by ALCO. More importantly, everyone needs to know what everyone else is doing."

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The intersection of risks and the role of regulation

The problems at Silicon Valley Bank stemmed from the confluence of interest rate and liquidity risk, a reminder that balance sheet risks must be considered holistically. Referring to Silicon Valley Bank's build up in interest rate exposure that followed the influx of liquidity Mr Choudry stated "A cardinal error to me by any bank anywhere is to assume that just because something's been the same for the last ten years, it will continue to be the same for the next ten years. That's the cardinal error if one is to take a risk to get rid of profit and loss because of the surplus," He added, "If one is to get the greater risk option, then one should really understand the additional risks associated with that and manage accordingly."

The role of regulation has expanded over the years to cover credit, market, operational and liquidity risks, and the capital and liquidity constraints imposed by the regulators, while improving financial stability, impact earnings.
However, the regulatory cadence should not set the tone for the bank. Mehdi Bouasria product director at Finastra emphasises the need for the ALCO to react to what is an uncertain financial environment, "The need for doing ALM just for the ALCO or to meet regulatory requirements is no longer sufficient. ALCO should not meet quarterly or semi-annually and expect to catch up with the market changes happening swiftly. Banks must ramp up their monthly or weekly monitoring to ensure a robust balance sheet."
This observation is especially true for smaller banks that sometimes lack the risk infrastructure found at larger institutions, and that often face more concentrated risks due to their limited geography or targeted market segment. Focusing on the community bank segment in the United States, Mr. Bouasria continues "Despite their small size, community banks still face various risks, and they need to effectively manage their balance sheet to ensure profitability, stability, etc."

The 2008 financial crisis prompted regulators to strengthen bank's high quality liquid assets to meet funding requirements under stressed conditions.
However, the 2023 liquidity crisis has raised other concerns particularly around a bank's access to cash to meet unsecured liability outflows, a scenario to which SVB was particularly vulnerable to.

ALM is more relevant than ever, and sometimes it needs a crisis for us to remember this fact. Each new era has its own unique challenges, for example the role that social media played in the demise of SVB. ALM too is evolving and increasingly draws in professionals from other areas in the bank such as trading risk that bring their own toolset. ALM may contain eternal risks, but as markets evolve, they can be seen through a different prism.

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About the author

Sean Coyne
Solutions Consulting Principal •
Global Sales, Finastra

Sean is a principal solution consultant in the Treasury & Capital Markets business at Finastra, where he works with customers showcasing Finastra solutions and developing prototypes. Sean has 25 years of experience in the financial industry working in financial engineering, quantitative research, consultancy, and software development roles. Sean holds a MsC in Software Engineering from Liverpool University and an undergraduate engineering degree from Dublin University.

Mark Benaharan, Mehdi Bousria, Moorad Choudry and Austin Elsey were all speaking at a webinar held by Finastra in May 2023 titled "Banking in a Era of Intense Competition and Regulation."

Contact us

About Finastra
Finastra is a global provider of financial software applications and marketplaces, and launched the leading open platform for innovation, FusionFabric.cloud, in 2017. It serves institutions of all sizes, providing award-winning software solutions and services across Lending, Payments, Treasury & Capital Markets and Universal Banking (Retail, Digital and Commercial Banking) for banks to support direct banking relationships and grow through indirect channels, such as embedded finance and Banking as a Service. Its pioneering approach and commitment to open finance and collaboration is why it is trusted by over 8,000 institutions, including 45 of the world's top 50 banks. For more information, **finastra.com**

Corporate Headquarters
4 Kingdom Street
Paddington
London W2 6BD
United Kingdom
T: +44 20 3320 5000

ID 38171 / 1123

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