Accounting Primer

VBA School of Bank Management

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What is ALCO?

Asset Liability Committee

Asset Liability Management

What Does ALCO Do?

Asset-Liability Management:

Determining and Measuring Interest Rates and Controlling Interest-Sensitivity

Asset-Liability Management

The purpose of Asset-Liability Management is to control a Bank's sensitivity to changes in market interest rates and limit its losses/maximize profits in its Net Income or Equity

ALCO Meeting Topics

- National and Local Economy
- Loan and Deposit Demand
- Investment Portfolio
- Monitoring Tools
- Policies

Financial Statements

Financial Performance is Reviewed

Income Statement

The Income Statement shows the cost to acquire funds and generate revenues from its uses.

How much we paid for deposits versus how much we earned on loans.

ALM GOALS

- Asset Liability Management is a management *process* with the goals of:
  - Maximizing and growing Net Interest Income
  - Minimizing and controlling financial risks
  - Maintaining adequate capital

Historical View of Asset-Liability Management

- Asset Management Strategy
- Took deposits for granted. Decision was "what asset do we invest the deposits?"

Historical View of Asset-Liability Management

- Liability Management Strategy

- Shift in thinking "Deposits aren't the only way to fund loans. Let's use sources with the cheapest price"

Historical View of Asset-Liability Management

- Funds Management Strategy
- More balanced theory today

Funds Management Strategy Objectives

- Control volume, mix, and cost of assets and liabilities
- Maximize spread between revenues and costs

Interest Rate Sensitivity Defined

Reflects the degree to which changes in interest rates can positively or adversely affect earnings or the economic value of equity.

When Market Interest Rates Change

- SO DO….
  - Loan Rates
  - Deposit Rates

Key Questions

- How quickly do loan and deposit rates change?
- Which side re-prices faster?
- What impact will this have on net interest income?

Interest-Sensitive Assets

- Short-Term Securities/Investments
- Variable-Rate Loans Made by the Bank to Borrowing Customers

Interest-Sensitive Liabilities

- Certificates of Deposit
- Money Markets Deposit Accounts
- Savings Deposit Accounts
- Variable-Rate Deposits

Interest Rate Risk

The Danger that Shifting Interest Rates May Adversely Affect a Bank's Net Income, the Value of its Assets or Equity

Asset-Sensitive Bank Has:

- Positive Dollar Interest-Sensitive Gap
- Positively Gapped = Asset Sensitive

Liability Sensitive Bank Has:

- Negative Dollar Interest-Sensitive Gap
- Negatively Gapped = Liability Sensitive

Understand Correlation
Asset Sensitive Banks

- Because assets re-price quicker than liabilities:

  - When Interest Rates <u>Increase</u>… Net Income <u>Increases</u>

  - When Interest Rates <u>Decrease</u>… Net Income <u>Decreases</u>

Understand Correlation
Liability Sensitive Banks

- Because liabilities re-price quicker than assets:
  - When Interest Rates <u>Increase</u>… Net Income ____________
  - When Interest Rates <u>Decrease</u>… Net Income ____________

Understand Correlation
Liability Sensitive Banks

- Because liabilities re-price quicker than assets:
  - When Interest Rates Increase… Net Income Decreases
  - When Interest Rates Decrease… Net Income Increases

Neutral Interest-Sensitive Gap

- Dollar Interest-Sensitive Gap is Zero
- When Interest Rates Change in Either Direction - NIM is Protected and Will Not Change

Cumulative Gap

The Total Difference in Dollars Between Those Bank Assets and Liabilities Which Can be Re-priced over a Designated Time Period

Aggressive Interest-Sensitive Gap Management

Expected Change in Interest Rates	Best Interest-Sensitive Gap Position	Aggressive Management's Likely Action
Rising Market Interest Rates	Positive IS Gap	Increase in IS Assets Decrease in IS Liabilities
Falling Market Interest Rates	Negative IS Gap	Decrease in IS Assets Increase in IS Liabilities

How Do Banks Respond to IRR?

- Asset-Liability Committee Manages
- Written Policies
  - $\pm$ 25% rate sensitivity
- Base decisions on expectations (pricing loans and deposits)

Problems with Interest-Sensitive Gap Management

- Interest Rate Attached to Bank Assets and Liabilities Do Not Move at the Same Speed as Market Interest Rates
- Point at Which Some Assets and Liabilities are Re-priced is Not Easy to Identify

4 Key Profitability Ratios in Banking

- Return on Assets (ROA)
- Return on Equity (ROE)
- Earnings Per Share (EPS)
- Loan-to-Deposit Ratio (L-to-D)

- Follow Along with In-Class Exercise

ROA

Indicator of managerial efficiency.

It tells how capable management is at converting assets to earnings.

Net Income/Average Assets

ROE

Measure of rate of return flowing to shareholders.

The benefit that stockholders have received from investing their funds in the company.

Net Income/Average Equity

Earnings Per Share

Income per share of common stock

Net Income/Average Shares Outstanding

Loan-to-Deposit Ratio

Measure of Liquidity

Net Loans/Total Deposits

It is best to compare financial institutions of similar size.

UBPR

- The Uniform Bank Performance Report Provided by U.S. Federal Regulators so that Analysts Can Compare the Performance of One Bank Against Another
- Based on quarterly reports.

UBPR

- Interest Income
- Interest Expense
- Net Interest Income
- Net Income
- Comparison to Peer
- Asset Growth
- % of Cash Dividends Paid

UBPR In-Class Exercise

Net Interest Margin

- What is your margin? Is your margin compressing?
- Measures the level of net interest income compared to average earning assets.
- The higher the better
- Annualized net interest income/average earning assets