ASSET/LIABILITY MANAGEMENT – YEAR 2

SECTION LEADER: DARREN D. HERRMANN

DESCRIPTION
Asset/Liability Management (ALM) presents information related to the financial management of financial institutions. The term “asset/liability management” refers to the processes of acquiring and investing funds to maximize net interest income, net income, and return on equity, while managing interest rate risk to earnings and the economic value of equity (EVE) of the financial institution, liquidity risk, and with regard to effective capital management. The course content reflects the balancing effort between maximizing profitability/shareholder value primarily through net interest income/margin management and managing capital, liquidity, and market (interest rate) risk. Because credit risk is dealt with in great detail in other classes, it is not a focus here.

The following topics will be covered during the course:
- Role and responsibilities of a financial institution’s asset and liability committee (ALCO) or risk management committee
- Profitability impact via net interest income and the key elements that impact it
- Interest rate risk measurement via earnings at risk sensitivity analysis and sensitivity analysis of EVE
- Impact of embedded options (prepayment, callable bonds, and early deposit withdrawal) on interest rate risk, etc.
- Liquidity risk measurement and management
- Ways in which to evaluate the risk/reward tradeoffs of ALM strategies

These topics will be presented and discussed from the following three perspectives:
1) Conceptual/Educational/Informational
2) Real World Examples
3) Regulatory

The material is also structured around the requirements for the Intersession Project in an effort to best prepare the students for success with that project.

PURPOSE
Asset/Liability Management emphasizes the application of economic, finance, and banking principles to the measurement and management of financial institution profitability and risk. The course introduces and reinforces financial concepts that financial institutions commonly use and emphasizes the evaluation of inputs and output and the interpretation of information. The purpose is to help students understand the trade-offs in financial decisions and the need for a formal asset/liability management structure and policy. The course builds off the Bank Performance Analysis and Asset/Liability Management classes offered in the first year by taking the measurement of profit and risk and expanding it to the entire balance sheet. It also provides additional background information for the third-year Bank Management Simulation course. Finally, it addresses and relates topics from the intersession project that will be completed between years 2 and 3.

OBJECTIVES
After successfully completing this course, students will be able to:
- Understand the drivers of net interest income and the components of net interest margin
- Understand what causes net interest income and EVE to change
- Describe the strengths and weaknesses of earnings sensitivity analysis (earnings-at-risk) and EVE
- Evaluate the impact of embedded options, such as loan prepayments and callable bonds, on financial institution profitability and risk
- Describe a procedure for estimating the rate sensitivity of deposits
- Have a basic understanding of strategies to manage interest rate risk
- Evaluate a financial institution’s liquidity risk profile and identify available sources of liquidity

FEATURES
Teaching methods include lecture, examples, and other illustrations of financial institution data. Students also complete an intersession project that requires them to apply the concepts to their own financial institution’s performance data, financial management decisions, and ALM process.