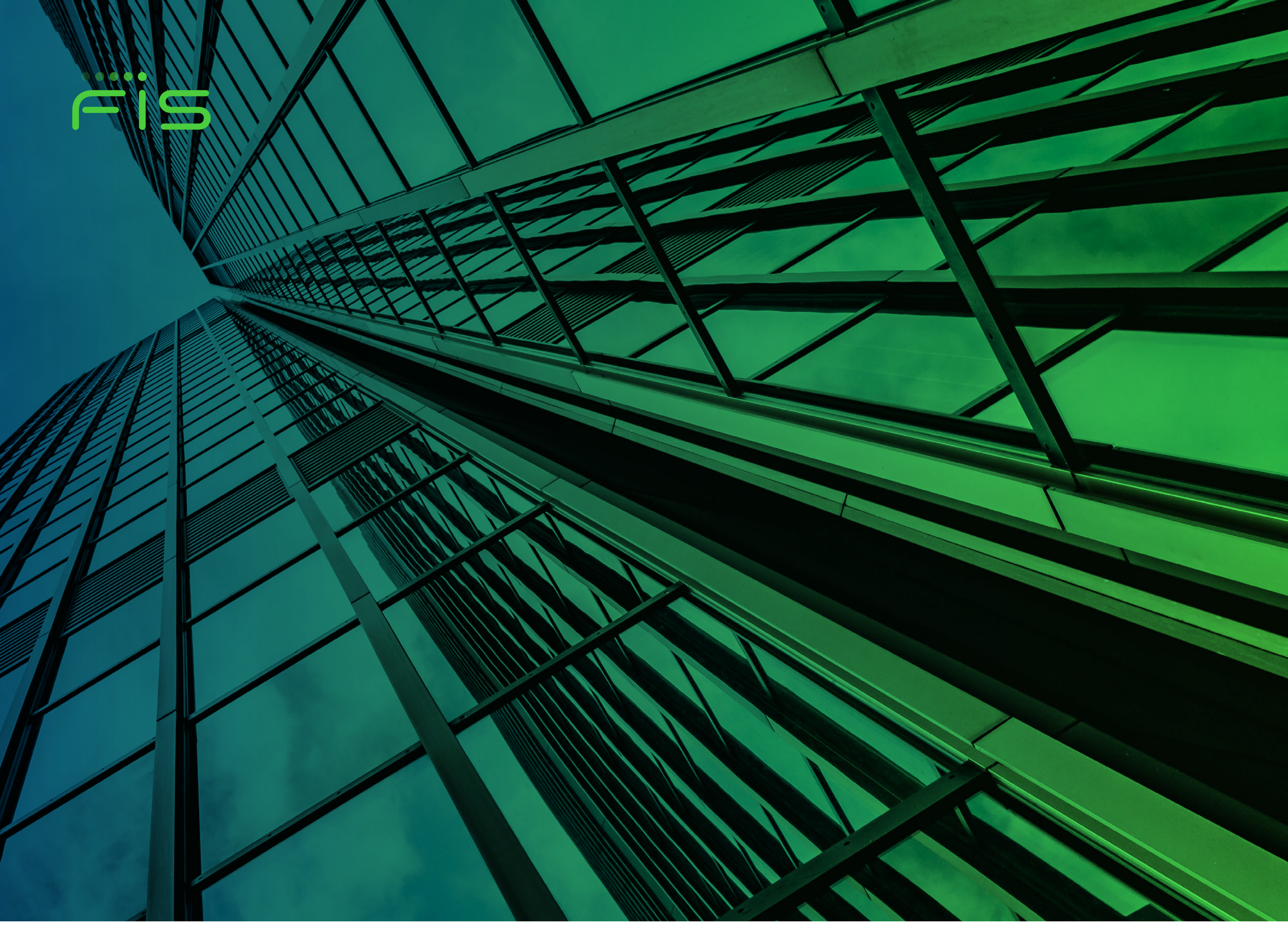


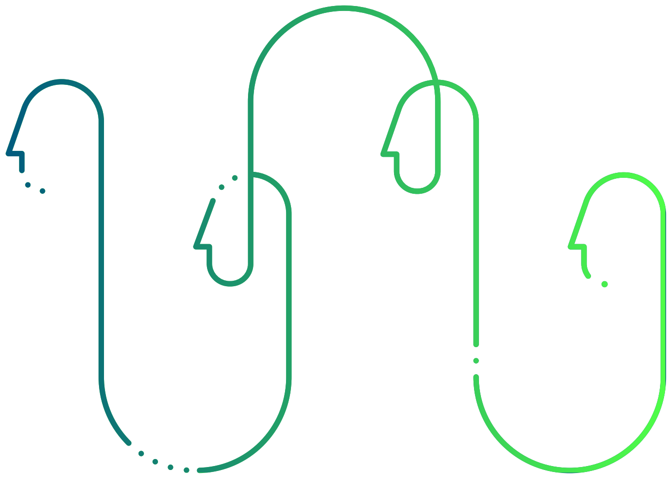
WHITE PAPER

ALM IN A RISING RATE ENVIRONMENT

November 2022

Introduction

It's been a long time since we've seen a real rise in global interest rates, after more than a decade of rate suppression thanks to central bank quantitative easing. With additional inflationary pressures due to supply side economic shocks of food and energy, driven by unforeseen geopolitical events, we now have seen price inflation moving beyond **11%**, impacting disposable incomes, producer costs and the real economy. Interest rate re-pricing is now in full swing, but have we reached the peak yet? While the upside is increased earnings, the downside is increasing credit loss provisions, and changes in customer behaviours as they seek to weather this inflationary storm. For ALM teams, this calls for recalibration of assumptions and behaviours that drives your balance sheet profile and as back-testing comes back in vogue.



New digital/challenger banks may have virtually no risk or experience with internal product switching across their back-book customer base and often have innovative products and new ways of servicing customers. New entrants to the market will benefit from a rising-rate environment in attracting volumes (particularly in raising deposits) and supporting yield enhancement through lending, leading to positive volume and rate changes on their balance sheet.

What does this changing environment mean for ALM – challenger banks or otherwise?

Banks are generally well positioned to increase yields and overall earnings through this volatile period and are broadly well capitalised and highly liquid.

Despite this strong starting position, it's time to review balance sheet assumptions and pricing strategies in this dynamically changing environment. Interest rates have been rising at a historical pace and many economies are on the cusp of a recession or have already entered a recession. Squeezed disposable incomes driven by a cost-of-living crisis and high interest rates have slowed demand for house purchases leading to falling property sale prices. While pension fund yields are presently shrinking, equally new product opportunities begin to emerge with the possibility to release equity for mature homeowners.

The present situation is unusual, as employment has generally remained strong post-pandemic. Global supply side physical inputs for manufacturing products still have not fully recovered—via a downwards price correction—from the pandemic, additionally fueled by geopolitical tensions. Despite that global demand for nonessential goods and services is now abating, we still have no clarity on when the upward spiral on food and energy costs impacting most countries will show signs of slowing down. As the supply side for physical goods and components is still generally restricted, despite global demand remaining high, food and energy shocks are impacting most countries and there is no clarity on when that may change.

Mindful of that potential continual risk, banks should re-evaluate their underlying assumptions in currently used models. It's vital to consider the impact of rising rates and changing customer behaviour, and how that leads to changes in the balance sheet profile and earnings volatility driven by changing sources of liquidity and funding.

Retail banking balance sheet management

Assumptions and behaviours

Now is the time to review your prepayment assumptions. For retail assets, effective lives (durations) are likely to increase in light of lower disposable income, and fixed rate borrower prepay rates are likely to reduce for the next two to five years.

Retail funding costs are starting to rise, with banks seeking to lock in on longer term fixed retail deposits. Predictions suggest that the impact of quantitative tightening and/or bank rate changes will further tighten conditions over the next 12 to 24 months.

Customer demand for the certainty of medium to longer-term fixed rates, on both sides of the balance sheet is rising faster than central banks' reference rates in some regions. Ensure you have access to timely and accurate information to see sustained changes in customer product behaviour, and close monitoring of your pipelines as well as understand how the balance sheet and income may evolve over the next 12 to 24 months.

ALM health checks

Economic view

Make sure to review business portfolio acquisitions or new business lines introduced within the last five years for accuracy of data, particularly around switching behaviours and borrower credit deterioration, that could potentially transition to nonperforming lending if price inflation, disposable income and business banking customer profit margins continue to erode.

Re-validate your ALM data flows with your Arrears and Collections teams in case these short-term price impacts turn into a full-blown economic downturn.

Accounting view

Review the evolution of your gap and sensitivity reports under dynamic simulations/scenarios to reassess volume, rate and maturity on the change to EVE/NII and overall risk profile in the balance sheet, both pre- and post-potential assumption changes.

Liability-heavy banks hedging their interest rate risk using (receiver) swaps and incurring an accounting mismatch are advised to review their hedge accounting programs and mitigation strategies—e.g., increase asset-driven rate sensitivity—as the swap revaluation effects will create temporary losses in PnL. Banks hedging their FX exposures using cross-currency swaps will need to assess any potential basis revaluation impacts given the demand for safe-haven currencies like USD, EUR, JPY and CHF, where potential increases may drive more significant cross-currency basis spread movements in the global financial markets.

Product pricing and FTP

Review pricing strategies and revalidate scorecard cut-off models to consider a higher cost of risk into both generalised product pricing and your funds transfer pricing process.

For example, a potential liquidity squeeze driven by falling stock of sight and short-term savings deposits (because of higher cost of living) might need to be reflected in the transfer prices in the form of increased liquidity premiums in the transfer pricing curve, for funding consumer lending and mortgage assets.

Liquidity management

Banks have remained highly liquid through the pandemic, with a significant surplus of retail funding, but should anticipate the likelihood of a gradual reduction in the stickiness of savings and level of current account balances. To date, as there has been significant amounts of liquidity available, retail-based funding presently remains cheap funding.

Banks are now starting to offer more competitive rates on savings, particularly on term deposits, but there is wide divergence on rates on offer, this may change as the demand for term savings increases. For softer currencies, and in a world where its easy to sign up a savings account through an app, some customers are looking for a harder currency as a more stable store of value, remember opportunities and innovation go hand-in-hand.

Central bank pandemic relief schemes at some point will be wound down as quantitative tightening kicks in, and that might impact the sources of liquidity and returns, e.g. the ECB's normalisation process in the Eurozone with the end of current favourable funding via TLTRO. So testing access and availability to wholesale funding markets in line with your ILAAP processes is key.

Residential mortgages

Overall mortgage demand for house purchases is slowing, and seeing downward price corrections on house sales. The demand for fixed rates has significantly risen over the last few weeks especially in regions where mortgage rates are fixed for shorter terms, as central banks are increasing rates quickly. Lenders having to withdraw and reprice mortgage products, as demand for fixed rates outstrips tranche size supply, as lenders scrabble to manage their fixed rate pipeline risks, on existing borrowers as well as new bank customers.

Review and update pipeline and pull though assumptions, and review from a number of dimensions by getting deeper granularity. Hence, it is sensible to talk to your underwriting teams to understand what's happening on the ground.

Commercial real estate

The expectation is that commercial real estate performance will continue to be impacted heavily through rising construction costs and the continuation of dampening demand as a result of the pandemic. This will weigh heavily on commercial performance. Yields are likely to remain weak and capital value growth may slow sharply.

Reverse mortgages and equity release

With an aging, retired population in central and western Europe, continued pressure on disposable incomes may prevail in the longer term. Lenders now see a real demand for reverse mortgages to further unlock equity from mature borrowers.

Revolving credit lines

Demand is increasing, so review assumptions with respect to the mix of "free payers" versus "extended credit takers", hence reviewing credit lines offered and their utilisation against limits is important. Constant exchange with your credit risk teams is key, as again they have the most granular insights e.g. increased missed payments, underlying shifts emerging to minimum payment, and by credit score for early warning indicators to a change existing borrower credit quality. There is also a new tendency to take out buy now, pay later (BNPL) products, which will likely increase the overall indebtedness of your retail customers with extended interest bearing repayment profiles.

New product development

Mortgage banks are uniquely placed to support mortgage holders to improve their carbon footprint, reduce energy consumption and bills, and improve the energy rating of private housing stock. Thanks to these conditions, the break-even point for investments is now far shorter, due to energy price pressure, and offers opportunities for product innovation for cross-selling to existing customers.

In conclusion

The next 12 months may prove to be a win for enhancing net interest income in most banks, as product yields should increase overall. However, we expect that there will be increasing pressure in some economies on NIM, coming together with rising provision levels and non-performing lending to create a drag on overall earnings.

For new digital and challenger banks who may be undercapitalised or operating with less liquid and diverse funding lines, their costs of funding will likely rise, and they will probably see changes in the credit quality of their books. The good news? Opportunities for growth remain strong despite the challenges, as long as net lending growth, credit policy and diversity of funding are carefully managed.

Find out more about Balance Sheet Manager here.

Contact us today.

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