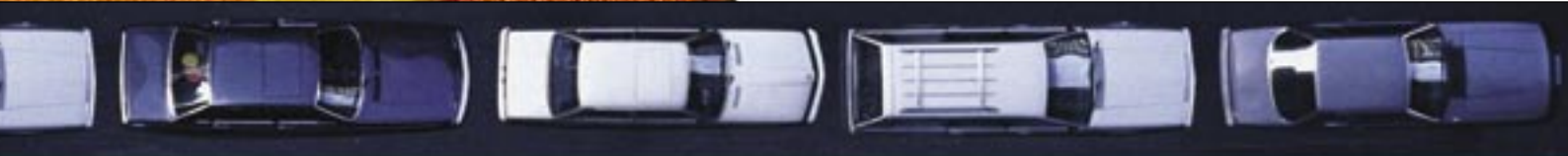
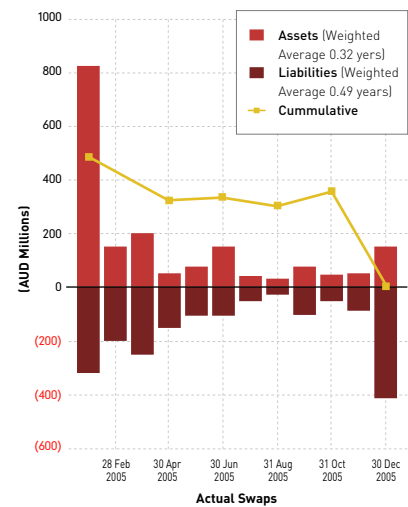


BRIDGE THE RISK GAP

Gap analysis has long existed as the centrepiece of interest rate risk management for the non-bank financial institution (NBFI) sector. However the aim of maximising net interest income (NII) on a risk-adjusted basis requires more than just matching the repricing terms on either side of the balance sheet.

There is now software available that easily allows NBFIs to use more advanced risk management techniques that go beyond traditional gap analysis, explains Michael Singh, CFA.

A funding gap can only provide an approximation of future NII volatility. The picture is incomplete because the analysis framework relies on simplifying assumptions. In particular, we assume that assets and liabilities reprice identically.



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Consider, for example, a \$50M group of liabilities that reprice after six months. The rate on the liabilities moves by one half of the change in the underlying reference rate. Using a classical approach we would seek to match the liabilities with a \$50M group of assets that also reprice after six months. If the rate on the assets reprices by the full amount of any reference rate change, then we are still exposed to NII volatility despite the gap report showing a matched position.

In reality, balance sheet behaviour is inherently complex. Some products may reprice partially or asymmetrically depending on the direction of interest rates. Some may reprice with time lags. In the case of demand deposits, some may reprice at discretionary rates.

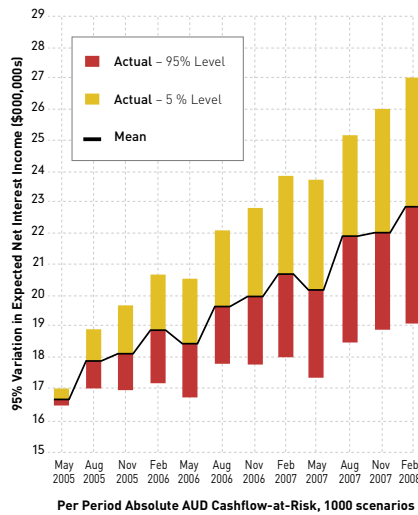
Product balances are likely to change when interest rates move. The market value of the balance sheet is affected and we may also need to consider the risks associated with principal runoffs and prepayments.

The limitations of traditional asset-liability risk management were recognised long ago. However, until now the technology required to use advanced techniques resided only with large financial institutions.

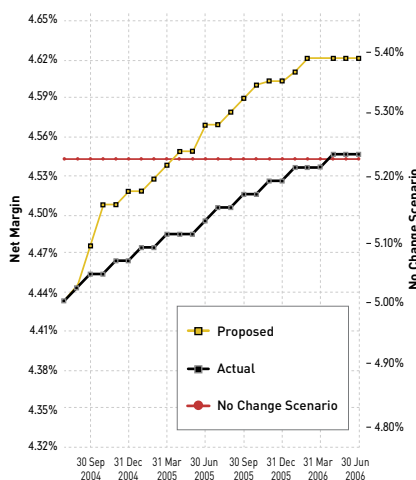
The result is that many NBFIs, such as credit unions and building societies, are still relying on gap analysis as their principal mechanism for interest rate risk management.

HOW CAN A RISK SYSTEM HELP?

Systems allow your institution to extend the focus beyond simple gap analysis to more strategic measures including net margin forecasts and importantly, net interest earnings-at-risk (NIER).



NIER analysis can be performed on a scenario basis using high and low interest rate forecasts. It can also use a Monte Carlo framework to dynamically simulate the balance sheet and build a distribution of possible outcomes at every future time period. NIER therefore looks beyond gap analysis and even Value-at-Risk (VaR), both of which are static measures.



NIER analysis can clearly identify the time periods where future NII volatility is high due to product repricing behaviour.

Risk systems also incorporate stress testing and mark-to-market capabilities that complete the interest rate risk picture. Risk systems can thus provide NBFIs with a powerful business strategy tool when combined with traditional measures such as the funding gap, duration and VaR.

There are other practical reasons for adopting a risk system.

When integrated with a core banking system, risk analysis becomes a seamless process eliminating drawn-out reporting processes.

Regulatory changes are also an important consideration. As supervisors step up their focus on risk management, NBFIs will be expected to have the tools to measure and manage their risks effectively.

Dealing with multi-faceted risk management methods has simply not been worth the effort for NBFIs in the past. But risk systems are now capable of delivering comprehensive risk management solutions within easy-to-use frameworks.

“Gap analysis is a good starting point but it is not an exact science and should be complemented by other methods.”

Best practice is leading the industry towards more advanced risk management techniques and NBFIs can take advantage of the technology available today.

Michael Singh is a consultant with Visual Risk. For more information visit www.visualrisk.com

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