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ALM – Why Doesn't Anyone Care Anymore?

A friend of mine asked me why Asset-Liability Management did not seem to be center stage anymore. It's a great question, and I had not thought about it previously. The more I thought about it the more I agreed with the statement. The hot topics today are PBA and ERM. ALM has become secondary. It seems like people think they understand ALM, which is interesting given how all the models broke down recently due to liquidity concerns. I just don't think people noticed that. It's as if, since no firms went under, it must not be a problem. Practitioners look at duration (or Key Rate Duration/Partial Duration) as the end all, but we should be optimizing the results with scenarios rather than using duration as a constraint. I think it is complacency. Since markets have been very stable, with trends somewhat predictable as the Fed preaches stability and provides leading indicators allowing investors to anticipate its actions.

I think the regulatory change that requires market values to be taken into account will lead to more accounting hedges, but probably not more actual economic hedging. It will take a spike/drop in interest rates for ALM to come back into focus. It has been calm for so long that people have become complacent about the risk. This is a mistake and a contrarian indicator.

The Fed reacts to each financial issue, which sends the message that someone will always be there to bail you out. Why wouldn't Wall Street encourage leverage and risk taking in such an environment? Each time the process plays out, the markets get closer to imploding. The taxpayers pay the price, and fiscal imbalances eventually lead to inflation. We need to remember that the Fed only impacts markets in the short run, and that it has minimal impact on the eventual long term course of events.

Hedge Fund Concerns

I read something in a mid-June WSJ describing how hedge fund withdrawals could lead to market discontinuities at the end of June and early July because so many funds allow only quarter end withdrawals. It will be interesting to see if some distressed sales take place.

Glass-Steagall

What will we eventually think of the unwinding of Glass-Steagall? Originally insurers, commercial banks, and investment banks were forced to separate. Now they can combine. There are rumors that some of the weaker investment banks may be bought by commercial banks. Is this healthy? I think not, because of the too big to fail argument. A relatively small Bear-Stearns can much more easily be absorbed into the system than a defunct firm that has branches across the nation, a credit card division, is a home mortgage originator and an investment bank on top of all of that. We are seeing high concentration risk in the banking sector already. This does not help. We have seen what tends to happen when a conservative product line likes municipal bond guarantors start to add to their risk profile by adding products with risks that are not fully understood.

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