ALCO - Blending Form & Function

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We have long accepted that the Asset/Liability Committee (ALCO) of a financial institution should be a driver of earnings and hoarder of net interest margin, watching both like a hawk. Unfortunately, a bias still exists that ALCO's paramount function is to appease regulators and "paper the file." Whether you are still developing your process by feeling out different reports and metrics or you are running a fine-tuned interest rate risk management machine, here is a recap of basic functions, a touch of history, and several ideas to consider.

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The ALCO process cannot just be window dressing. Even the best looking reports need to do more than look pretty. There was a recent trend in the automotive industry punctuated by adorning cars with hood scoops, spoilers, and side vents that served no purpose beyond aesthetics. The auto industry has since shed the non-functional eye sores. Similarly, regulators are now looking under the proverbial hood and want to see that all systems and components actually contribute to management's efforts to manage balance sheet risks. Gone are the days of aiming for the least-costly solution to simply earn a passing grade.

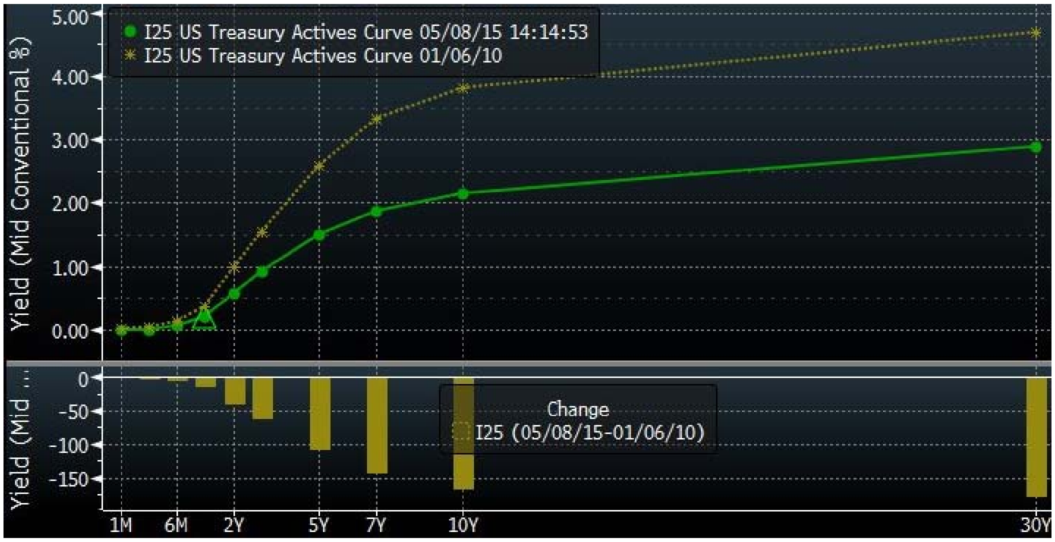
This isn't necessarily news, but it bears repeating because the industry has demonstrated that it can be a slow process to migrate ALCO to be a true asset rather than a liability within the institution. Even the best run asset/liability models and committees still have room for improvement.

Typically reporting to the board of directors, ALCO should include a carefully selected cross section of insightful management team members (and third-party advisors when appropriate). Those representing skill sets in borrowing, lending, investments, wholesale and retail funding should be at the table. Others may be welcome, too, dependent on the culture and makeup of the institution. An Asset/Liability Committee's functions are well-defined but not simple. Because the Committee is responsible for validating the asset/liability model, monitoring risk tolerances, and setting and reviewing policy guidelines, they (no matter who is attending) must be armed with a host of easy to read, robust reports.

Regulators and management will be impressed when changes in assumptions are highlighted during your process for validating the data produced by the model. Key assumption sensitivity testing is an opportunity to flex your banking muscles and improve accuracy of results. Identify all critical model assumptions in writing, and painstakingly describe the discussions that resulted in the new assumptions (including data to support the conclusion). For simpler institutions back-testing their model, a narrative will often suffice. Strongly consider integrating budgeting and planning efforts into the asset/liability modeling process. While not commonly linked, it could be a good choice for those looking to make a leap forward in ALCO efficacy. This allows for development of dynamic strategies, with a forum for assessing progress or recognizing the impacts of a lack thereof.

Speaking of a lack thereof, consider running no-growth scenarios if not already doing so. Also include prolonged rate shocks and non-parallel shifts in the yield curve that may particularly impact areas of the balance sheet that have embedded optionality. Keep in mind that some of the most valuable data is derived from projections beyond 12 months. In addition to running various curve twists, give fair consideration to falling (as much as rising) rates. When the FDIC presented "The ALCO Process: A View From the Regulatory Arena," among other things the FDIC noted concern about "the importance of having robust processes for measuring and mitigating, as necessary, exposures to potential increases in interest rates." All are still valid points, but a quick look at the chart below illustrates how valuable it is to maintain a balanced approach to ALCO and interest rate risk management. The 10-yr. Treasury has almost always been lower since that point. That's enough history; the point is to go beyond the regulators' requirements and make the process a meaningful part of running your business.

10-Year Treasury Yield Curves (as of January 2010 & May 2015)



Next, ALCO must be intimately familiar with understanding and interpreting risk tolerances. Quickly disseminating information on funding source diversification, limitations on certain deposit types, and large or new accounts is a key to the Committee's success. Specific attention should also be paid to fixed income portfolio analysis and interest rate risk. It is also ALCO's responsibility to identify and quantify exposures in these areas – and in the budget, too – and make policy exceptions, when necessary. Ultimately, the most helpful element is to track not just levels, but trends. This may be the change your ALCO process needs to reach the next level of analysis and reporting.

The amount of data ALCO members must absorb on a regular basis cannot be understated. Develop a set of easily digestible dashboards to display information related to Contingency Funding Plans and Liquidity Policy Guidelines, including deposit composition, any single sources relied upon heavily, and the relative marketability of assets. We do see positive trends in this area of reporting and encourage all institutions to adopt a color scheme approach for indicating when limits are reached. Avoid criticism related to why the group continued with established limits by proactively making those decisions intentionally and with documentation. New, freshly relevant limits may trigger internal discussion, improved profit potential, reduced risk, other immediate action, etc. The red, yellow, green color scheme concept will speed up your meetings (are any too fast already?) and assist your board in understanding the health of the organization. That's a win. Imagine applying it to your guidance for a liquid asset cushion, for example.

Yes, maintaining a functional ALCO process is a regulatory requirement, but we believe it should facilitate dynamic discussions and critical thinking by each organization's best and brightest. When looked at as a powerful management tool, it can bring cohesiveness to budgeting, planning, strategies, team members, and the board of directors.

- *"The ALCO Process: A View From the Regulatory Arena." CDFI Fund - U.S. Treasury. N.p., 31 Oct. 2012. Web. 26 May 2015. <http://www.cdfifund.gov/>.*
- *"Asset/Liability Management Committee." Partnership for Progress. Board of Governors of the Federal Reserve System, n.d. Web. 26 May 2015. <https://www.fedpartnership.gov/bank-life-cycle/start-a-bank/asset-liability-management-committee>.*