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ASK ALM FIRST

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How Can my Depository Make ALCO More Effective?

The Asset and Liability Management Committee (ALCO), which is responsible for the oversight of balance sheet risk management, is one of the most important operating committees of any depository institution. A proper functioning ALCO will result in more profitable decisions. Here are five best practices to help make your ALCO more effective.

1. Understand Structural Options

In ALCOs generally operate under two types of structures: Strategic or Operational. Each has unique differences, however, there are several best practices that both structures can use to achieve their goals. Understanding the differences between a strategic and operational ALCO will help create an ALCO process that achieves the institution's risk management objectives.

First and foremost, it must be understood that both structures are acceptable for a depository institution. In fact, some institutions have both or choose to combine both strategic and operational goals into one ALCO. A strategic ALCO is usually comprised of key managers from finance, lending, marketing, operations, and the Board. The emphasis of a strategic ALCO is forward looking. This committee is focused on strategic development and decision making which impacts the long-term goals of the institution. The strategic ALCO is less focused on the day-to-day functions and more directional in nature. For example, a strategic ALCO will be focused on what business lines should be the core of the institution and may ask questions like: How can capital be best deployed? What additional resources are needed to achieve our desired goals?

An operational ALCO is comprised of management staff and is responsible for the oversight of balance sheet risk management. This will include interest rate risk, liquidity risk, capital risk, budgeting, policy and regulatory compliance. The focus is less on making long-term, strategic decisions and more on effectively managing day-to-day functions. Most often, the type of ALCO structure is driven by the size and complexity of the organization. The depth of the management team and the strength of the Board will also be relevant factors.

2. Encouraging Participation & Preparation

No matter the structure, an effective ALCO must have a strong Chairperson and contributing members. Members should come prepared as meeting materials are provided well in advance. The meeting's time and duration should be set to reduce normal routine distractions. The agenda should be concise, and discussion should be focused on pertinent issues. The committee should be actively making decisions, not just using the meeting to disseminate information. The committee should be results oriented with any assigned tasks documented in the minutes and distributed shortly after the meeting

3. Create a Feedback Loop

A well-functioning ALCO will use a strategy feedback loop for better decision making. The goal is to make informed and profitable, risk-adjusted decisions. Members will need information from ALM models and tools to help them assess and measure the risks inherent in the balance sheet. Strategies can then be developed and implemented to mitigate any unacceptable levels of risk. Decision makers must be confident in the model's assessment of those risks. Any lack of confidence may lead to indecisiveness and ultimately costly mistakes. A strategy must be monitored to verify it is accomplishing the intended results. If not, the strategy must be altered to realign with the desired goals. Remember, a balance sheet and its assessed risks are at a single point in time. Reassessing risk is ongoing as the balance sheet and the environment we operate in changes constantly.

4. Focus on Managing, Not Avoiding, Risks

Assessing and mitigating risk is the main function of ALCO, not the complete elimination of risks. Totally avoiding risk does not guarantee survival and most likely will not lead to profitability or effectively serve your key stakeholders. Managing risk through a well-established process of educating the staff, Board members, and regulators is paramount. Within this context, ALCO should manage all balance sheet risks including interest rate, liquidity, credit, option, concentration and operational. Each risk carries its own set of risk/reward scenarios. These risks should be managed holistically as one risk could offset or compound another risk. It is essential that ALCO focus on both sides of the balance sheet. Liabilities can be an excellent tool to offset some of the risks on the asset side of the balance sheet.

5. Have the Right Data, Tools & Systems in Place

Critical to all decision making is the proper systems, tools, and reporting mechanisms. Most ALM models cover interest rate risk, option risk, and liquidity as defined by cash flows, but may not address some of the other inherent balance sheet risks. Operational, concentration, and credit risk will require supporting systems to assess their impact more accurately on the balance sheet. Understanding the input data, assumptions used, and limitations to any model will improve the confidence of decision makers. Proper back testing and variance reporting will improve the accuracy of the reports.

Remember, the goal of ALCO is to better understand all the risks inherent in the balance sheet resulting in more profitable decisions. The proper assessment of risk, coupled with the correct risk appetite creates the environment for improved profits. A well-run ALCO is one of the keys to a depository institution's success.

Want to learn more? Contact us at info@almfirst.com to discuss your institution's specific needs in more detail.