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THE ASSET/LIABILITY COMMITTEE:

What Regulators Want and What Board Members Need to Know

WHITE PAPER

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Executive Summary

While figuratively speaking all roads lead to Rome, in the banking world they do in fact lead to the ALCO (Asset/Liability Committee). The group responsible for the coordinated oversight of balance sheet risk management has evolved into perhaps the most important operating committee of a bank. This fact has not been lost on the regulatory community as examination/supervision has delved into ALCO-related activities with substantially greater breadth and depth than we have ever witnessed.

As a result, bank directors are thirsting for more education on ALCO-related activities and are becoming increasingly involved in the ALCO process.

The purpose of this article is not to dive into the details, but rather to put regulatory expectations and prudent asset/liability management practices into perspective.

ALCO: A Brief Primer

Simply stated, ALCO manages the risk-return inherent in the buying and selling of money.

For example, your bank "buys" money from businesses and households in the form of deposits. It may also "buy" money from a variety of other sources, such as borrowings from the Federal Home Loan Bank. It then "sells" this money as loans to commercial enterprises and consumers, as well as to other entities through the purchasing of investment securities such as agency bonds and mortgage-related securities.

This "buying" and "selling" of money results in the acceptance of credit, liquidity and interest rate risk. Net interest income is the difference between what you buy and sell the money for. It represents what your bank gets paid for the risk accepted.

The degree to which your bank can buy and sell money is limited to the amount that can be supported by your bank's capital position. Banks with high capital are akin to a manufacturer operating with excess plant capacity, while those with little excess capital are more similar to a manufacturer at or near full capacity.

So, there you have it. The purpose of ALCO is to maximize net interest income over both the short and long term (i.e. throughout business cycles) while managing within acceptable board approved risk tolerances for credit risk, liquidity risk, interest rate risk and capital.

Accordingly, it is important that the bank's key-decision makers are actively involved in the ALCO process. These include president/CEO, CFO, treasurer, senior commercial and residential loan officer(s), as well as the head of retail banking and the head of marketing.

Director Responsibility

Directors must be confident that they understand the pertinent governance issues, that the appropriate guidelines for risk measurement and management are established, and that the necessary monitoring, reporting and decision-making mechanisms are in place for ensuring compliance with guidelines and regulations, as well as for supporting the bank's strategic plan.

As it relates to ALCO, regulatory guidance is fairly hot off the press, with interagency guidance given as recently as January 2012. * This guidance offers a number of important elements that should be present within your bank's ALCO process. The following summarizes what directors need to know as it relates to the key areas of focus for ALCO: interest rate risk, liquidity risk and capital.

Interest Rate Risk

Banks must ensure that they can articulate the nature and degree of the exposure of earnings and capital to changes in interest rates. Of equal importance, they must be able to demonstrate and document how this understanding impacts their decision-making process; especially as relates to how incremental strategies of significance are expected to impact interest rate risk (earnings, liquidity and capital as well).

Regarding risk measurement, the regulatory community has clearly stated its strong preference for robust interest rate risk modeling activities that include both earnings and economic value of equity-based measures. They expect analyses to be conducted on the bank's current balance sheet without predictions of growth (so as not to mask embedded risk with growth) and to include:

• A broader array of interest rate change scenarios including 300 to 400 basis point shocks and non-parallel yield curve shifts (e.g. where the interest terms don't change evenly),
• The capturing of option risk (e.g. prepayments, loan caps/floors, call options on bonds and borrowings),
• Longer-term earnings simulations (e.g. five years) versus the two-year horizons that most banks prepare, and
• Stress testing of key assumptions, including loan prepayments, deposit pricing sensitivity and the impact of deposit decay and/or mix changes.

A key take away for directors relates to the importance of documenting the assumptions utilized in interest rate risk models, as well as performing appropriate back-testing of model results versus actual performance.

Regulators are engaging in much more detailed dialogue relating to how assumptions are developed and the basis upon which they are determined. They are looking for sound logic and the use of supporting bank-specific data for key assumptions. We are seeing a growing number of banks reviewing a summary of key assumptions with their boards on an annual basis, with significant changes reported quarterly.

Liquidity Risk

Given the high profile industry challenges of recent years, it should come as no surprise that the expectations for what constitutes prudent liquidity risk management have changed greatly. New guidance requires "comprehensive liquidity risk measurement and monitoring systems" that include:

- more formalized operating and contingency funding plans that read more like policies and procedures manuals,
- risk monitoring that includes "early warning system" metrics/triggers,
- detailed cash flow projections and stress scenario testing, and
- documented relief strategies in the event of stress.

In effect, liquidity management must become a robust/proactive risk monitoring and management process with appropriate supporting policies, procedures and reporting channels. Basically, your bank must demonstrate how it will prevent a potential liquidity challenge from becoming a liquidity crisis.

In addition to ensuring appropriate contingency planning, ALCO oversees ongoing liquidity management. In this regard, ALCO should discuss loan and deposit growth expectations, examine expected investment cash flow, and identify upcoming funding maturities. This review should be documented and serve as the basis for strategy discussions regarding how projected funding shortfalls or excesses will be managed.

Capital Adequacy

ALCO is not where credit risk management resides. It is however, where management discusses credit trends, non-performing asset levels versus capital/reserves, credit concentrations and other credit-related metrics that may impact strategy development; especially as it relates to capacity for growth.

Like a manufacturing firm, it is important for ALCO to know whether the bank is operating, for example, at 75 percent or 95 percent plant capacity and whether earnings and growth expectations are creating or absorbing capacity. This is critical for developing appropriate pricing and product strategies for loans and deposits, and an important input for investment strategy discussion.

While not directly a responsibility of ALCO, directors should understand that regulators with increasing frequency are expecting all banks (not just those with current challenges) to prepare detailed capital plans, including a determination of minimum acceptable capital ratios, definition and analysis of stress scenarios and delineation of remediating/contingency strategies.

Your bank should define, defend and document what constitutes "well-capitalized"—before someone else does it for you.

Some Final Thoughts

Effective ALCOs are a profit center for banks. They conduct productive meetings that management actually looks forward to attending. Board members ask to rotate through the committee for educational purposes.

Being proactive versus reactive makes a difference, and does influence regulatory perceptions—and perceptions do matter.

So next time the topic of ALCO comes up consider asking a few questions, such as:

- If a regulator engaged the board in a discussion of interest rate risk what are the five most important items we need to know about our bank's position and the impact on bank strategy. Ditto for liquidity risk management.
- What are the most important assumptions impacting our measurement of interest rate risk, and how sensitive are our results to them? Have we stress tested the impact of those assumptions on our estimated risk levels and relationship to policy limits?
- Are we confident that our ALCO process is leading to better decision-making? How do we know? How is our bank's current balance sheet risk position

impacting loan and deposit pricing and product strategy, as well as investment strategy?

- How much "parked money" have we estimated to potentially exist within our deposit base and where does it likely reside? Assuming that these monies leave when economic conditions improve and interest rates increase, what are the implications for earnings, liquidity and interest rate risk?
- Has the bank taken the appropriate steps to ensure that all of its critical risk management models have been independently reviewed for accuracy and robustness and, where appropriate, back-tested (comparing actual results to model projections)?

A new day has dawned for bank risk management, and the regulatory community understands that most of the roads run through ALCO. The regulatory bar has been raised and the expectation is that it will be cleared.

**Guidance can be found in the Interagency Advisory on Interest Rate Risk (January 2010), a January 2012 follow-up on Frequently Asked Questions on the interest rate risk guidance, Interagency Guidance on Liquidity Risk Management (April 2010) and Supervisory Guidance on Model Risk Management (April 2011).*