Getting the Directors On-Board with ALCO

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Recently, I spent a few days with bank directors at the ICBA Directors Conference in sunny Scottsdale, Ariz. I began my session asking all directors to raise their hands (obviously, everyone did). Then I asked those who sat in on their community bank's asset liability committee (ALCO) to keep their hands raised-half the room dropped their hands. Finally, I asked for those who enjoy their ALCO meetings to keep their hands raised. About five remained proudly raised.

What does that say? Does it speak more about the directors or about the state of ALCO meetings in banks today?

In speaking with the directors, the reasons for the lack of interest became clear—they did not seem to comprehend all that was being discussed and what they could comprehend did not seem all that relevant. And I could sympathize with their concerns. In speaking with as many community banks as I do each year, I hear similar concerns echoed in my discussions—ALCO is viewed as more of a regulatory compliance meeting and less a vehicle to drive discussion and decision making. No wonder nobody wants to attend!

Imagine running your community bank's ALCO meetings like mini-strategic planning sessions. ALCO reporting should provide succinct information on the long-term risk profile of the institution. Keep in mind, this is not a budgeting exercise. The goal of interest rate risk management is to identify exposure to changes in rates so that ALCO can determine the risk mitigation steps it will take. To have the best information, ALCO must see a greater time period than one or two years—a five-year net interest income simulation allows cashflows, assumptions and rate movements to fully play out and provide the near-term (managing horizon) and long-term (planning horizon) risk exposures.

An effective ALCO will run a multitude of rate scenarios (for regulatory compliance, assumptions support and strategy development) and needs to determine which are the most critical to focus on for decision-making purposes. While identifying risk exposures to plausible increases in rates, do not lose sight of how the balance sheet will react to a continued flat-rate environment or even additional declines in longer-term rates (often overlooked by ALCO but having significant impact on earnings).

Net interest income simulations provide a clearer representation of long-term risk than economic value of equity (EVE) analyses. Net interest income simulations factor in the reinvestment of cashflow at current rates while the EVE assumes a liquidation of the bank by discounting all cashflows to present value. Additionally, the EVE exposure is swayed greatly by the assumptions made on lives for non-maturity deposits (longer lives = more value while shorter lives = less value). These results can cause outside regulators to have an opinion of an exposure to rising rates (based upon EVE) that is contradictory to the simulation results. It is critical for a bank's ALCO and board of directors to understand these analyses and be able to defend their position.

ALCO, at its most effective, should have members discuss issues facing the bank, risk measurements and exposures (interest rate risk, liquidity and capital) and weigh the risks and rewards of potential strategies aimed at managing the risk and maximizing potential earnings.

ALCO's decision making should never be reactionary, and decisions should always be discussed with key personnel involved utilizing the tools (simulations, stress-testing and documentation for all aspects of the risk management process—interest rate risk, liquidity and capital) of an effective ALCO process.

Forward looking ALCO meetings that focus on managing the risk on the balance sheet, maximizing earnings and effectively managing liquidity and capital will be best positioned to prosper in the next rate cycle. Board members on ALCO should understand the risk on the balance sheet and what the bank is doing to manage it. Only then can it most effectively set policy. ALCO is the meeting where all key members get together to have open discussions about driving the ongoing success of the bank. Who wouldn't want to be a part of that?

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He is a top-rated speaker and frequent author on numerous balance sheet management topics and conducts customized executive and board level workshops to enhance understanding and involvement in the ALCO process.

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This article first appeared in the November-December 2014 issue of Community Bank Director, a publication of ICBA.