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Building a More Effective ALCO in a Dynamic Rate Environment

The Asset Liability Management Committee (ALCO) is an integral part in the management of a financial institution. It is the committee responsible for effectively managing the balance sheet while also optimizing performance and achieving the goals set forth by the board. Unfortunately, this committee oftentimes has the reputation of being tedious. The primary issue has been that most ALCOs had very little to do during the long stretch of near zero interest rates and took on a very passive approach.

That situation has drastically changed with the FED taking significant action to fight inflation with unprecedented increases in interest rates. More importantly, many institutions saw record highs in liquidity move to record lows in under one year. More than ever, ALCOs need to be realigned toward a more strategic approach so that the institution can be put in the best possible position to succeed.

Education Is Necessary to Successfully Transition

The first step toward moving the ALCO from static to a more dynamic approach is education. The issue for most ALCOs is that members may not fully understand the various interest rate risk tests we run, the assumptions involved, and how those assumptions shape results. Therefore, during the ALCO meeting we spend more time covering these concepts and less time on strategy. This can lead to less engagement from key decision makers who are focused more on the current issues they are facing.

Especially regarding asset liability management (ALM), all members of the ALCO need to understand and agree on the key assumptions being made. Assumptions need to be reasonable, supportable, and as institution specific as possible. The risk of poor assumptions is an inaccurate view of the potential threats to the balance sheet.

NEV/EVE, for instance, needs to implement market rates for each loan product so that we can better understand the risk we are taking with the mix of loans and our pricing strategy. The NII, on the other hand, needs to have betas that accurately reflect the pricing decisions we will make as rates change to identify the risks to margins.

Getting the Right People Involved

All too often we see issues arise from different departments being siloed. When the team responsible for loan pricing is not talking to the team setting deposit rates, we start to see issues such as tighter margins, liquidity pressures due to misaligned pricing, and interest rate risk issues. The lack of communication between these siloed departments and the ALCO means the strategic objectives of the institution get lost in the day-to-day activities.

The ALCO is typically comprised of some members of the board and key C-level executives. In many institutions, it can be beneficial to expand committee membership to include other key departments to get the entire institution on the same page. This does not mean that the ALCO needs to be a large committee, but rather that the institutions can rotate key members in and out as needed.

The result should be that all key decision makers are on the same page when it comes to strategy and how their decisions ultimately affect the rest of the institution.

Focus on the Right Information in the Right Way

Some ALCOs have developed a reputation of being “boring” or “monotonous” because of the information reviewed and how it

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is presented. ALM is the cornerstone of the ALCO meeting, and the information contained in an ALM report is invaluable. The issue is that typically the ALM data is from a previous quarter while most members of the ALCO are focused on current issues. Reviewing that data in a more clear and concise way that shifts to a more strategic forward-looking focus can create a more energetic and engaging meeting. Focusing on the key information in reports and ignoring the "fluff" ensures that the ALCO covers what is needed.

Though this process could be different for each institution, it generally involves looking at key national and local economic data, key financial trends or management targets, liquidity reports, investment portfolio analysis, and of course the ALM.

ALCO members must have the relevant data to anticipate threats to future earnings and then develop strategies to minimize those threats.

Everything Revolves Around Strategy

The institution's strategic goal should be the North Star that guides the way the balance sheet is managed. ALM is the compass that shows us if we are on the right path toward that strategic goal. For the ALCO to be more effective, rather than just reviewing the results and how they compared to last quarter, the committee must connect those results back to the main strategy.

Some key questions for the ALCO to consider are:

1. Is the institution making proactive decisions to prepare the balance sheet for a changing rate environment?
2. Is the institution's greater margin risk in a falling rate or rising rate environment, and what can we do to minimize the risk?
3. Are we considering the changing competitive landscape?
4. With offerings from fintechs taking an increasing share of loans and deposits from traditional financial institutions, how can we position our institution to minimize the risk to our balance sheet?
5. Is the institution properly managing risks vs rewards? For example, does the institution understand the impact rising cost of funds has on our loan pricing decisions?

By asking these types of questions the ALCO can create a meeting environment that encourages different staff members to join the strategic conversation, thus creating an important feedback loop for management to adjust strategy.

To be effective, the ALCO needs to get key decision makers of the institution on the same page and shift to a more strategic focus. ALCO meetings can then go from being reactive, focusing on past results, to being proactive in taking those results and molding a strategy around them. In this dynamic rate environment, a more effective ALCO can put a financial institution on the best path to success.

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