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The ALCO: making the most important bank committee more effective and more real

Thought Leadership Series

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Ringo Starr entitled his compilation album *Blast From The Past*. On occasion when speaking or writing about the importance of a bank's asset-liability committee (ALCO) and how to ensure it remains fit-for-purpose, I'm reminded of that charming exercise in nostalgia. Some topics remain important in perpetuity, and in banking making the ALCO effective is one of them.

A committee however is, after all, just another committee. Making a committee effective, and "real", to the business, is a challenge that goes beyond the mere procedural and into the realm of the cultural. And as befits a forum that is viewed typically as a "technical" one, the challenge is not trivial: how do we make the ALCO meaningful to the business lines, so they derive the full value-added that the primary balance sheet management group should be delivering?

ALCO and its importance

Before addressing the question we've posed at the top we'll start with our own blast from the past, to wit;

"A greater number of financial institutions are enhancing their risk management function by adding to the responsibilities of...the asset and liability committee (ALCO)...and integrating...traditional interest-rate risk management with credit risk and operational risk."

"In order to fulfil this more enhanced function [ALCO] will require a more strategic approach to [its] work."

"These are Board-level decisions."

(From *The Bond and Money Markets: Strategy, Trading, Analysis*, Butterworth-Heinemann 2001, p. 536)

An indication of that book's age is given from the inside back flap, which shows the author with a full head of hair!

Another extract, also dating from before the bank crash, sets out the ideal behind ALCO:

"The ALCO will have a specific remit to oversee all aspects of asset-liability management, from the front-office money market function to back-office operations and middle-office reporting and risk management."

(From *Bank Asset and Liability Management*, John Wiley & Sons Ltd 2007, chapter 8)

But while these are laudable ideas and great theory, they don't necessarily make an ALCO fit-for-purpose – if by that we mean an ALCO that ensures that the bank's balance sheet remains robust and viable in perpetuity. Simply organising a monthly ALCO meeting and setting up a formal terms of reference (ToR) for it is not enough. Every failed bank in 2007 and 2008 had an ALCO.

Two subsequent publications, including chapter 9 from *The Principles of Banking* (Wiley 2012), which presented recommended ToR and membership guidance for the ALCO, and chapter 10 from *Moorad Choudhry Anthology* (Wiley 2018), which recommends greater authority for the ALCO by dint of making it report direct to the Board, continued on this theme of ALCO effectiveness. The bottom line was, and is, that as balance sheet robustness is the last word on bank survivability in a stressed environment, the ultimate guardian of the balance sheet must be ALCO.

That's why it was very welcome when the UK regulatory authority (then called the Financial Services Authority, now the Prudential Regulatory Authority or PRA) issued a "Dear CEO" letter containing guidelines for effective ALCO practice in January 2011. This contained some real gems, including that ALCO should:

- proactively control the business in line with firms objectives; focuses on entire balance sheet;
- act as the arbitrator in the debate and challenge process between business lines;
- focus on effects of future plans / strategy at bank and business line level;
- ensure issues are fully articulated and debated;
- engage in active dialogue amongst various members and display a strong degree of challenge.

An ALCO that really did operate along these lines would be harder to render ineffective. Of course, the culture will come from the top, as it does in all groupings, and if the committee Chair is inclined towards the above behaviours, then there is more chance that ALCO will be able to act in line with these recommended guidelines. If the Chair is not so inclined, there is more chance that the ALCO is rendered less effective.

But let us suppose that a bank did do all the things we've described up to now. Imagine that the organisation structure gives the ALCO real authority, it acts as a genuine and open debating chamber, and its membership and ToR are fit-for-purpose. Is that enough?

ALCO and its meaningfulness

A question I get asked frequently at seminars and workshops is, "How can we make ALCO more meaningful, especially to the business lines?" Alongside that is the related, "Often the metrics reported in the ALCO pack aren't 'real' to the business lines, for example earnings-at-risk (EaR) or economic value of equity (EVE)…how can we make the indicators more meaningful to the business, such that they actually assist the business in their planning and balance sheet optimisation?"

These are good questions. It's true that that certain risk indicators reported in the ALCO deck do not tell the business line managers anything of genuine value that assists them with their day-to-day work. And when this happens, it makes the ALCO process less effective than it could be, because it makes it more difficult for the first line of defence (1LOD) to engage fully during the meeting and during the overall ALCO process. It is certainly true that in many banks ALCO is seen as a "technical" committee that is less relevant to the front line business.

ALCO needs to answer these questions fully, because otherwise it risks becoming less effective than it needs to be.

In the first place, balance sheet risk metrics reported in the ALCO deck need to include meaningful indicators that actually help the business line heads manage their business from the product origination stage onwards. This goes beyond the metrics included for regulatory purposes: items such as CET1 ratio and LCR would be included at the start to demonstrate compliance with regulatory requirements. We might label these "Tier 1" metrics. However this list of indicators tends to include the NSFR, EVE, EAR and VAR type metrics, and whilst these are of course all very important Tier 1 metrics, they aren't necessarily the ones that connect easily at the coal face (although, ideally they would be).

To make ALCO effective at all levels and across the business lines requires that it also reports metrics that are transparent and easily discussed, and can be understood straight away in terms of impact at the assets and liabilities origination stage. For instance,

- Liquidity: for example, customer loan-deposit ratio (LDR) and size of high quality liquid assets (HQLA) portfolio as a share of the balance sheet, and other measures that the 1LOD will use on a daily basis to help understand the business, alongside the standard regulatory metrics;

- Capital: for example, buffer over the total capital requirement (TCR) and capital available to absorb unexpected losses on a going concern basis, and any "pinch points" over (say) the next two quarters where this level may be a constraint on the lending plan;

- Earnings: for example net interest income (NII) and net interest margin (NIM), and critically the sensitivity of these indicators to one or more changes in internal and external balance sheet factors (such as customer and product type changes);

- Non-traded market risk: for example, the ΔNII metric and its sensitivity to "business-as-usual" market changes alongside the prescribed stress scenarios;

There are of course any number of additional risk exposure numbers one can report, and the final suite of them will be a function of the size and business model of the institution. Including these additional risk indicators in the Tier 1 list of metrics alongside the standard regulator-driven ones in the monthly ALCO pack will make ALCO more meaningful to the business, and thereby assist in making the meeting itself more productive as all attendees engage in the proceedings.

In terms of order and layout, it is good practice to have the ALCO deck aligned fully with the bank's Board risk appetite statement (RAS). (Ideally, the RAS takes it cue from the ALCO deck, but the other way round is more common). Using LDR again as an example, this metric may appear in the Liquidity and Funding section of the RAS in the following format:

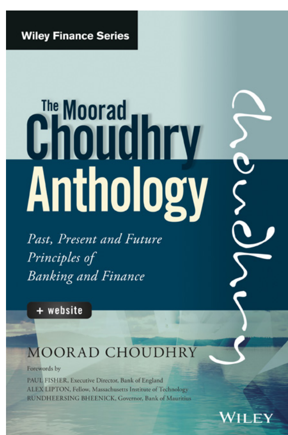
Executive Responsible	Liquidity Risk Indicator	Red	Amber	Yellow	Green	Rationale	Comments
	Customer Loan-Deposit Ratio	>110%	>95%	>85%	<85%	Sets the bank's appetite for the extent of customer surplus funding of the balance sheet	LDR excludes any central bank facilities funding

The format should then be replicated in the monthly ALCO MI pack, thereby giving instant confirmation of compliance with the "green zone" of the RAS. Hence in this instance:

Liquidity Risk Indicator	Red	Amber	Yellow	Green	Comments
Customer Loan-Deposit Ratio				82%	

This format should be used for all risk metrics reported in the ALCO pack. Tier 2 and Tier 3 metrics, that may not appear in the main body of the RAS, would ideally be reported in the same way, again to enable ALCO attendees to note instantly that the balance sheet shape and structure is "green".

And in the second place? ALCO needs to be as open as possible, and a genuine debating chamber. This second point is more "cultural" than technical, and presents not an insignificant challenge. But getting the first point right will assist in making the meeting itself more meaningful to all attendees, especially the business lines. And that is a "good thing" for what is the most important committee in the bank.



References

For ALCO operating model and governance structure:
Moorad Choudhry Anthology: Past, Present and Future Principles of Banking and Finance, John Wiley & Sons Ltd (2018), Chapter 10

For template ALCO Terms of Reference:
Moorad Choudhry Anthology: Website, Chapter 10 folder

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