The 7-Step Guide to an Effective, Dynamic ALCO

Developing an Outcome-Based Asset/Liability Management Process

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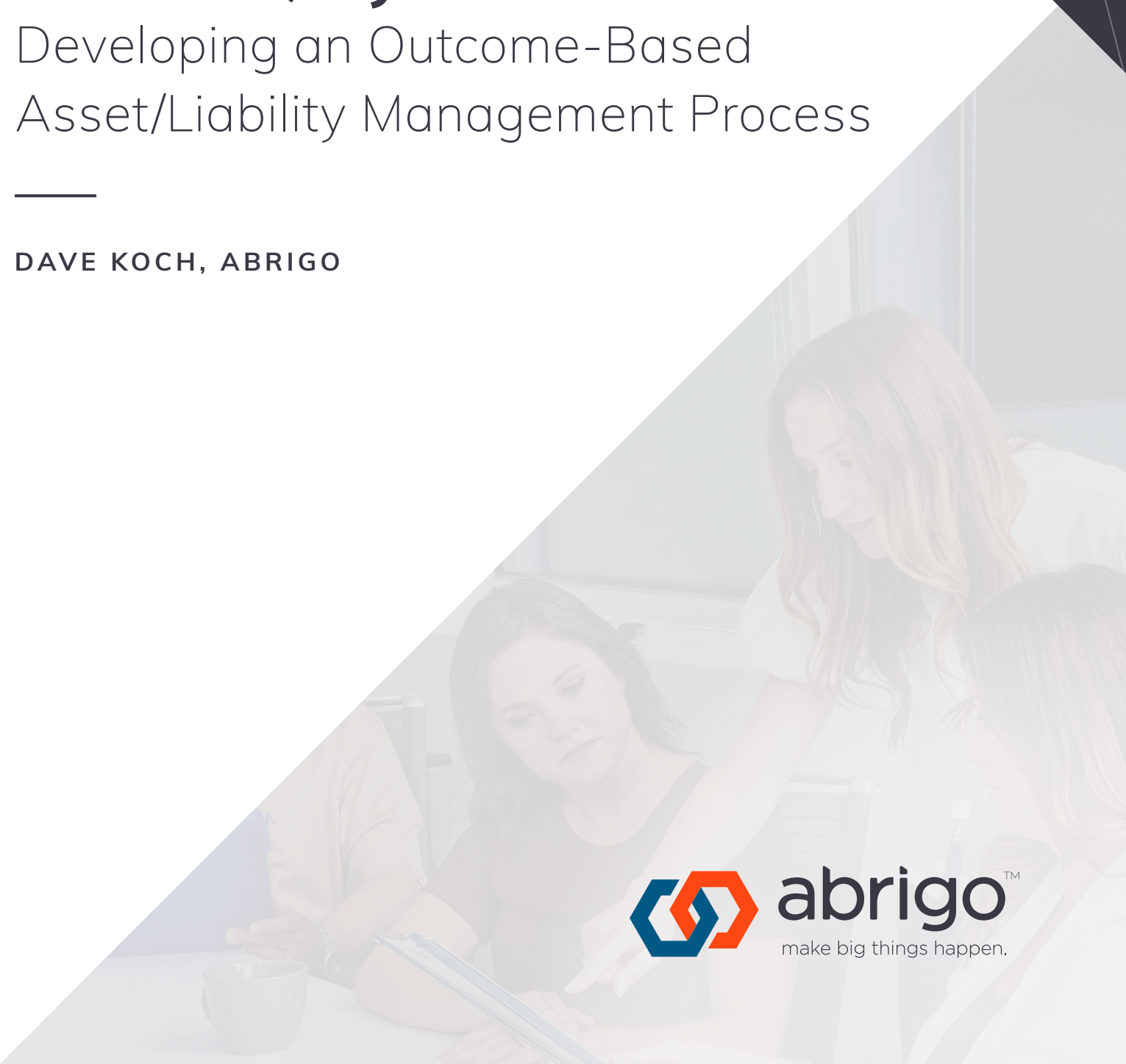

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EXECUTIVE SUMMARY

The asset/liability management process at a financial institution should not be limited to one that "checks the box" of meeting regulatory requirements. Rather, institutions and Asset/Liability Management Committees (ALCOs) with a dynamic ALCO process are able to inform decisions related to strategy as well as risk management. This whitepaper outlines seven steps to developing an effective, dynamic ALCO process.

INTRODUCTION

For some time, community financial institutions and their Asset/Liability Management Committees (ALCOs) have been encouraged to upgrade their ALCO process to a more effective, outcome-based ALCO that actually informs decision making rather than simply "complying" with regulatory requirements. Since the crisis in 2009, the regulatory focus of the asset/liability management process has changed significantly. Examiners began asking more probing questions about institutions' understanding and use of the modeling tools and various assumptions. No longer are they simply looking for a huge packet of results. What does that mean for financial institutions today? It is time to invest the time, effort, and attention to all of the critical elements that impact the institution's asset/liability results and process. Below are the steps that will enable a financial institution to address those critical elements.

STEP 1: REVIEW CAPITAL PLANNING

A major lesson and key outcome from the economic downturn is that capital remains king! Since the recession, lawmakers and regulators have wrestled with how much capital a financial institution needs to be safe, as well as how exactly to account for the capital by changing definitions of what counts as capital. This debate is not new and has followed every financial crisis since deregulation. Regardless of the regulatory noise of the day, it is clear that successful financial institutions actively assess risks and hold capital levels commensurate to those risks. Too much capital is costly to shareholders and market needs, while too little brings on high costs for compliance and little room for error. Capital requires the most basic element of effective asset/liability management – building a balance between growth, risk, and return. Step 1 of an effective, dynamic ALCO is to step back and review your capital planning process. Is the process one that combines the strategic planning goals of the organization with its market opportunities to arrive at planned growth, earnings, and capital levels? Are we truly assessing potential risks within the plan to ensure we hold enough of a buffer to withstand unforeseen changes?

A strong strategic financial planning process takes your board and management team through capital planning that sets realistic and achievable financial goals and outlines an approach toward meeting these goals over time. During the board portion of the process, the key goal is alignment on top priorities. These priorities act as the guideposts for action for the asset/liability team in times when performance may be challenged.

The strategic financial plan should yield a high-level 3-5 year plan for financial performance with goals and priorities integrated into the asset/liability policies. This plan should be reviewed and updated annually as a part of the strategic planning process.

STEP 2: ASSESS RISKS IN PLANS

With target performance levels set and clear goals and priorities identified, attention turns to quantifying risks in the

current balance sheet that may impact our ability to meet the goals set. This involves the development of a dynamic forecast using a solid asset/liability-planning model. Major financial risks to be managed include:

- Earnings at risk
- Current value at risk
- Forecast value at risk, showing long-term risks in executing the plan
- Liquidity risks
- Credit risks

This is an area for the ALCO to take stock. Many ALM models will allow you to assess these risks effectively. Most often, the issues lie within the institution. Lack of resources, talent, or time gaps are most often the enemy of an effective use of the ALM tool. If your institution has been doing the same thing in the ALCO over the years, how can it be improved or modified to offer more complete and dynamic looks at the future? Identify the gaps in your approach and consider bringing in a second perspective to see a new view.

STEP 3: DEVELOP KEY ASSUMPTIONS FOR RISK ASSESSMENT

Asset/liability models depend on external sources for major assumptions that impact risk. Assumptions on prepayment speeds, non-maturity behaviors, pricing formulas, etc., traditionally have come from "the market." The problem with "market" assumptions is that they may have little resemblance to your institution-specific behaviors and actions. This is one area where regulators have spent a good deal of time pressing institutions for more understanding of the impact these assumptions have on your risk profile. A more effective ALCO will depend greatly on the variance of institution-specific behaviors compared to "market" assumptions for critical components. Key assumption areas include:

Non-maturity Core Deposit Behaviors: Core deposit studies are not new, but the approach and use of the data has grown. Core studies look at the historical behaviors of account holders, traditionally in non-maturity accounts, and they attempt to quantify the level of repricing and longevity in these key deposits. This single assumption can have the greatest impact on interest rate and liquidity risk levels. Post financial crisis, financial institutions saw a surge in the level of non-maturity deposits compared to other forms of funding. When combined with extremely low interest rates, small changes in the assumptions of "at risk" funds or in how quickly the institution might have to pay for funds can change the overall risk position for earnings and value.

Core studies have evolved beyond the typical ALM model input process to a more robust set of tools to help measure overall changes in typical depositor preferences, activity levels, share of wallet, etc. The need for consistent, stable supplies of deposits to fuel your institution's growth requires a hard look at how you are investing in, measuring, and controlling that fundamental need.

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Prepayment & Early Withdrawal Analysis: Loans and time deposits don't always act like the contract terms suggest. In order for the ALCO to manage capital, earnings, and risk, it is imperative that the modeling results reflect accurate projections of planned cash flow. Asset/liability teams should perform a comparison of actual vs. planned prepayment and early withdrawals and update model projections accordingly. Note also that prepayment speeds

impact other calculations, such as exit price and the allowance for credit losses under the current expected credit loss model, or CECL. These assumptions must be consistent, and ideally from the same source of truth, for best results.

Loan Pricing Assumptions: In order to execute the financial plans from Step 1, management must ensure that pricing actions on loans and deposits provide for the proper rate levels to cover risks, costs, and profit needs. What is your institutions' approach to rate setting for both "rate sheet" loans and for commercial "deal type" loans? How does your day-to-day process match up to the "assumptions" used within the ALM model? Model risk on this key area is one area still often overlooked by regulators and institutions when back testing. A strong ALCO looks to build consensus between financial needs and the rate/product term needs of the lending department. Strong and consistent loan pricing discipline brings these two sides together to build a plan on achieving the growth goals in the financial plan with an eye toward the pricing of risks inherent in reaching those levels. Key to success is ensuring that loan officers have access to the pricing tools needed to practice the pricing approaches, as well as clarity on the way in which these models are built so they have the ability to construct a variety of profitable deals to get the loans on the books. The financial plan outlines necessary levels of production to achieve the goals. Loan pricing tools must be properly configured to ensure well-priced deals, and they must be delivered in a way that loan staff can understand and use.

Deposit Pricing: The most important driver of profitability is likely the ability to attract and maintain deposits at a reasonable cost as compared to alternative funding sources. As part of the strategic financial planning process, we believe that every institution taking time annually to develop core funding strategy is crucial to the long-term franchise value of an institution. Deposit pricing is best managed in the context of an overall plan for deposit funding needs, product deliverables, and approach to rate setting. Having a forum to determine when and how to offer new products, take pricing actions, etc., to attract, maintain, and manage funding levels and costs goes well beyond most community financial institutions' approach to deposit management. As mentioned above, we are seeing the extension of core deposit studies into this area as control mechanisms for assessing the health and success of funding plans.

Credit Risk Assessment: Much has been written and debated about the appropriate way to assess and underwrite credit risk. Whatever your thoughts are on this subject, it is without doubt that the impact of these assumptions has a direct effect on overall capital and earnings. A strong and dynamic ALCO requires an understanding of loss ratio by product, so that the plan for the loan loss allowance levels are accurately modeled in the forecast, as well as in the loan pricing components. Again, this "shared" assumption has an impact in many of the individual areas of risk management. By incorporating the credit risk assumptions in to the ALM model, you are able to stress test the credit risk component as part of the overall plan, not just as a separate risk, which is a key goal of a dynamic ALCO process.

STEP 4: REVIEW AND REDEVELOP POLICIES

With a changing process comes a need for better policies and controls. Currently, many institutions have a series of policies aimed at managing different risks, independent of other risks. With the movement of the industry toward enterprise-wide risk management comes the need for a reworking of the board polices in place to control risks. When is the last time you did a full review of board limits or made recommendations on changes/additions to ensure the board has proper controls on management to ensure risks are measured and managed in accordance with the capital plan?

STEP 5: INCORPORATE SENSITIVITY STRESS TESTING

Stress testing is a "buzz-word" that can mean many things to different people. Stress testing comes in two forms. The most traditional and familiar stress test is called a "sensitivity" test. In sensitivity testing, key assumptions are modified to show how a change in their value impacts the performance of the institution. Changes are made primarily to determine which assumptions have the greatest

influence on the outcome. Think of it like a ranking system. Changes are not based on any type of assumption about market conditions, expectations, or reality. They are truly a stress test designed to show how important these key drivers are to the ALCO. For years, this is the type of earnings-at-risk analysis most institutions have run.

Think about it. We assume that the balance sheet will not change, but market interest rates will go up or down by some exorbitant amount, immediately, and then stay at that new level forever! We then assess the risk to our earnings or capital in that event. But what is this analysis really showing us? How well the institution will perform? No, it is a measure of how a fast move in rates might influence the level and direction of earnings. We run these same types of test for other key financial risks like credit and liquidity. If we are trying to manage our institution to the capital plan goals, sensitivity testing each area individually, while important and required, is simply not the answer. Implementing a more complete approach to stress testing is described next.

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STEP 6: INCORPORATE SCENARIO STRESS TESTING

The second form of stress testing is "scenario testing". This form of testing is more useful in the ALCO process as it considers how changes in different scenarios will affect different risk levels. This testing is the basis of enterprise-wide testing for real results.

ALCO/management should develop scenarios based on expected and unexpected economic and market forecasts that align changes in predicted balance sheet levels, credit and liquidity risk assumptions, etc., and show how these real scenarios may impact the performance of the institution relative to the capital plan objectives. These scenarios should be tested at least annually with "sensitivity" tests incorporated to get a real picture of potential risks to the plan.

The idea of scenario testing seems like a lot of work, but it is an extension of a good projection process. Projections, like the annual budget, make some assumptions about market conditions, risk levels, growth, pricing, etc. Those are combined to produce a result. Scenario testing takes that result and combines the forecast with the information from the individual sensitivity tests that helped us identify key assumptions that drive risk. So, if our forecast looks fine in our initial projection, but we rerun that projection with changes to the top two or three factors that might be plausible and have a big impact on results, are we well on track for financial performance? That's scenario testing stage 1.

STEP 7: EDUCATE AND TRAIN

In order to understand new roles, regulations, responsibilities, and controls, both the board and institution staff must understand what has changed, how the changes are different, and what their roles and responsibilities are in the process. When is the last time your board or ALCO had some specific one-on-one training or deep dive into key items that influence results? Regular education of the key stakeholders is critical to ensuring alignment with responsibilities and consistency between decision-making and risk taking.

Economic challenges come and go. We had been lulled to sleep by 10 years of low and stable rates. But it appears that now, our economic environment appears more active, and potentially volatile. While continued use of stand-alone ALM solutions may suffice for regulators, it may well not meet the needs of shareholders of many institutions, or it may leave opportunities on the table that can help drive our economy. Community financial institutions are the lifeblood of our local economic growth. Willingness to manage risk has long been the hallmark of local decision-making, and to

ensure that is done well, a broader and more comprehensive approach to the risk measurement and management process needs to be taken.

Following these seven steps will help your institution identify the areas of highest need in your ALCO process in order to take your asset/liability risk management to a more robust and meaningful level.

CONCLUSION

Financial institutions have the opportunity to manage risk and add strategic value in the ALCO process if they take the time to develop an ALCO process that goes beyond simply "checking the box" of compliance.

ADDITIONAL RESOURCES

Whitepaper: Stress Testing: Why It Shouldn't (And Won't) Go Away

Webinar: CECL and Your ALM Model

Webinar: Analyzing Core Deposits for Risk Management and Loan Growth

ABOUT THE EXPERT

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Dave Koch is Managing Director of Advisory Services with Abrigo and a lead faculty member of the Graduate School of Banking at the University of Wisconsin – Madison. He specializes in executive-level advisory services and is actively involved with capital planning strategy, loan, and deposit pricing, evaluating interest rate risk, and other ALM concerns of clients. During his 25-year tenure with FARIN, now part of Abrigo, Dave has shown his deep commitment to helping community financial institutions survive and thrive. He is a featured speaker at regional and national industry events and has addressed Chief Examiners and Deputy Commissioners from 36 states about interest rate management and how new regulations impact small- to mid-size institutions. Dave has also spoken on economic and risk-related topics at member meetings of the Federal Home Loan Banks of Dallas, Indianapolis, and Des Moines.

ABOUT ABRIGO

Abrigo is a leading technology provider of compliance, credit risk, lending, and asset/liability management solutions that community financial institutions use to manage risk and drive growth. Our software automates key processes — from anti-money laundering to asset liability management to fraud detection to lending solutions — empowering our customers by addressing their Enterprise Risk Management needs.

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