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# ALM AND CREDIT RISK

## Abstract:

Credit risk is the main risk exposure of the vast majority of banks in any country. It represents a primary risk to the balance sheet. In a financial institution, credit risk management must be the responsibility of the Asset and Liability Committee (ALCO). The recommended operating model is that ALCO has effective authority to monitor, and ultimately approve, all operational aspects that impact the balance sheet.

Individual business lines will manage their respective credit risks under the direction of the credit risk committee which also sets the firm-wide policy. Management of credit exposure (at the balance sheet level) is frequently undertaken by the treasury or ALM department, through use of credit derivatives, for example.

The nature of ALCO oversight is technical: capital, liquidity, market and non-traded market and other cash flow impacts on the balance sheet. Given this core aspect of ALCO's role, the need arises to establish a technical sub-committee of ALCO, perhaps called The Balance Sheet Management Committee (BSMCO), chaired by the Treasurer, to review the balance sheet and escalates issues where necessary to ALCO. Membership of BSMCO is at one level below the senior executives (CEO, CFO, CRO) with the exception of the Treasurer.

The other recommended technical sub-committee of ALCO is the Product Pricing Committee / Deposit Pricing Committee (PPCO/DPCO). This is a smaller committee whose remit is to ensure that, based on the recommended model, all pricing decisions are made by ALCO. Products in question would be customer deposit products, perhaps extended to customer asset products if deemed necessary. PPCO (or DPCO) has delegated authority to approve specific changes to standard rates for one-off transactions.

Given its importance to the balance sheet, ALCO can only undertake its mission effectively if it has final authority on credit risk exposure and credit risk appetite. This means the overall policy of the Credit Risk Committee must fall to ALCO review.

ALCO is responsible for through-the-cycle sustainability of the balance sheet. Since credit risk exposure is the main negative impact potential on the balance sheet, ALCO must have oversight of it. This does not mean day-to-day running and minutiae of credit risk origination. It means approval of policies, monitoring of exposure and approval authority on significant transactions and any policy changes. This research presents such recommendations for effective implementations of a bank ALM process.

## Keywords:

Asset liability management, treasury, credit risk

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