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MODULE 6

ASSET LIABILITY MANAGEMENT



OUTLINE

- Asset Liability Management (ALM) in b
- Components of Liabilities
- Components of Assets
- Significance of Asset Liability management
- Purpose and objectives
- Prerequisites for ALM
- Assets and Liabilities Committee (ALCO)
- Activities of ALCO

INTRODUCTION:

- The process by which an institution manages its balance sheet in order to allow for alternative interest rate and liquidity scenarios.
- Banks and other financial institutions provide services which expose them to various kinds of risks like credit risk, interest risk, and liquidity risk.
- Asset-liability management models enable financial institutions to measure and monitor risk and provide suitable strategies for their management.

DEFINITION:

Asset Liability Management (ALM) can be defined as a risk management mechanism to address the risk faced by a bank due to a mismatch between assets and liabilities either due to changes in liquidity or changes in interest rates.

- Liquidity is an institution's ability to meet its liabilities either by borrowing or converting assets.
- Apart from liquidity, a bank may also have a mismatch due to changes in interest rates as banks typically tend to borrow short term (fixed or floating) and lend long term (fixed or floating).

COMPONENTS OF ASSETS AND LIABILITIES

- COMPONENTS OF LIABILITIES:

- ✓ Capital
- ✓ Reserves and Surplus
- ✓ Deposits
- ✓ Borrowings
- ✓ Other liabilities and Provisions

COMPONENTS OF LIABILITY

1. Capital:

- Capital represents owner's contribution/ investment in the bank.
- - It serves as a cushion for depositors and creditors.
- - It is considered to be a long term source of funds for the bank.

2. Reserves & Surplus

- Components under this head includes:
- I. Statutory Reserves
- II. Capital Reserves
- III. Investment Fluctuation Reserve
- IV. Revenue and Other Reserves
- V. Balance in Profit and Loss Account



3. Deposits

This is the main source of bank's funds. Deposits are classified as deposits payable on 'demand' and 'time'.

They are reflected in balance sheet as under

- a) Demand Deposits
- b) Savings Bank Deposits
- c) Term Deposits



4. Borrowings:

Borrowings include Refinance / Borrowing from RBI, Inter-bank & other institutions

- I. Borrowings in India
 - i) Reserve Bank of India
 - ii) Other Banks
 - iii) Other Institutions & Agencies
- II. Borrowings outside India

5. Other Liabilities & Provisions

- It is grouped as under:
- I. Bills Payable
- II. Inter Office Adjustments (Net)
- III. Interest Accrued
- IV. Unsecured Redeemable Bonds
(Subordinated Debt for Tier-II Capital)
- V. Others (including provisions)

COMPONENTS OF ASSETS

- 1) Cash & Bank Balances with RBI
- 2) Balances with Banks and Money at Call and Short Notice
- 3) Investments
- 4) Advances
- 5) Fixed assets
- 6) Other Assets

COMPONENTS OF ASSETS

- ***1) Cash & Bank Balances with RBI***
 - I. Cash in hand
 - (Including foreign currency notes)
 - II. Balances with Reserve Bank of India
 - In Current Accounts
 - In Other Accounts

- **Balances with Banks and Money at Call & Short Notice**

I. In India

i) Balances with Banks

a) In Current Accounts

b) In Other Deposit Accounts

ii) Money at Call and Short Notice

a) With Banks

b) With Other Institutions

II. outside India

a) In Current Accounts

b) In Other Deposit Accounts

c) Money at Call & Short Notice

2) Investments

A major asset item in the bank's balance sheet. Reflected under 6 buckets as under:

I. Investments in India in:

- i) Government Securities
- ii) Other approved Securities
- iii) Shares
- iv) Debentures and Bonds
- v) Subsidiaries and Sponsored Institutions
- vi) Others (UTI Shares, Commercial Papers, COD Mutual Fund Units etc.)

II. Investments outside India in

- Subsidiaries and/or Associates abroad

3) Advances

The most important assets for a bank.

- A. i) Bills Purchased and Discounted
 - ii) Cash Credits, Overdrafts & Loans repayable on demand
 - iii) Term Loans
- B. Particulars of Advances:
 - i) Secured by tangible assets (including advances against Book Debts)
 - ii) Covered by Bank/ Government Guarantees
 - iii) Unsecured

4) Fixed Asset

- I. Premises
- II. Other Fixed Assets (Including furniture fixtures)

5) Other Assets

- I. Interest accrued
- II. Tax paid in advance/tax deducted at s
(Net of Provisions)
- III. Stationery and Stamps
- IV. Non-banking assets acquired in satisfac
of claims
- V. Deferred Tax Asset (Net)
- VI. Others

Significance of Asset Liability Management

- *Liquidity risk*
- *Interest rate risk*
- *Currency risk management*
- *Funding and capital management:*
- *Profit planning and growth.*

Purpose and objectives of ALM

- An effective Asset Liability Management Technique aims to manage the volume, maturity, rate sensitivity, quality and liquidity of assets and liabilities as a whole so as to attain a predetermined acceptable risk/reward ratio.
- It is aimed to stabilize short-term profits, long-term earnings and long-term subsistence of the bank.



Prerequisites for ALM

- 1. Awareness for ALM in the Bank staff at all levels, supportive Management & dedicated Teams.
- 2. Method of reporting data from Branches/ other Departments. (Strong MIS).
- 3. Computerization-Full computerization, networked.
- 4. Insight into the banking operations, economic forecasting, computerization, investment, credit.
- 5. Linking up ALM to future Risk Management Strategy.

Assets and Liabilities Committee (ALCO)

- ALCO, consisting of the bank's senior management (including CEO) should be responsible for ensuring adherence to the limits set by the Board. It is responsible for balance sheet planning from risk - return perspective including the strategic management of interest rate and liquidity risks.
- The role of ALCO includes product pricing for both deposits and advances, desired maturity profile of the incremental assets and liabilities, It will have to develop a view on future direction of interest rate movements and decide on a funding mix between fixed Vs. floating rate funds, wholesale vs. deposits, money market Vs. capital market funding, domestic vs. foreign currency funding.
- It should review the results of and progress in implementation of the decisions made in the previous meetings.

Activities of ALCO

1. ALCO decision making unit- Responsible for balance sheet planning from risk return perspective.
2. Monitoring the market risk levels by ensuring adherence to the various risk limits set by the bank.
3. Articulating the current interest rate view and a future direction of interest rate movements.
4. Deciding the business strategy of the bank, consistent with the interest rate view, budget and pre-determined risk management objectives.

Activities of ALCO

5. Determining the desired maturity profile and assets and liabilities.
6. Product pricing for both assets and liabilities
7. Deciding the funding strategy i.e. source and liabilities or sale of assets.
8. Reviewing implementation of decisions made previous meeting.

IMPORTANT QUESTIONS

- 1. What is ALM? June/July 2016 (3 marks)
- 2. Discuss the components of liabilities and assets on banks balance sheet. June/July 2016 (10 marks)
- 3. Discuss in detail: ALCO Dec.15/Jan16 (10 marks)
- 4. Explain the significance of ALM Dec.15/Jan16