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ASSET LIABILITY MANAGEMENT IN CO-OPERATIVE BANKS

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Introduction

The inflow outflow of deposits i.e., liability and inflow of loans and investments i.e., assets has its own pattern. Basically deposit maturity patterns and loan maturity pattern are different back in time as per commitment. So outflow of liability is assured. But there is no such reliable assurance for asset incoming. Though the borrower has made commitment to pay back at certain time, the commitment may not be followed. Premature withdrawal is one more factor. All this crates mismatches between asset and liability. Mismatch beyond certain point may create problems of liquidity. Therefore ALM is very important.

Meaning

ALM is a comprehensive and dynamic framework for measuring, monitoring and managing the market risk of a bank. It is the management of structure of balance sheet (assets and liabilities) in such a way that the net earnings from interest is maximized within the overall risk-preference of the institutions. The ALM functions extend to liquidity risk management, management of market risk, trading risk management, funding and capital planning and profit planning and growth projectio**n.**

Definition

"A technique companies employ in coordinating the management of assets and liabilities so that an adequate return may be earned".

Asset Liability Management (ALM) is the administration of policies and procedures that address financial risks associated with changing interest rates, foreign exchange rates and other factors that can affect a company's liquidity.

Overview about ALM

With the liberalized approach of regulators i.e. the govt. and the RBI, the co-operative banks are also given free environment for further operational freedom on certain areas. Thus, banks are free to determine their own interest rates on deposit. The rates of advance are also determined by the banks subject to minimum Lending Rate (MLR) conditions. Banks are investing in Government and other permissible securities but the interest income on those investments is market related and fluctuating. All these factors and intense competition is making banks position on profitability very sensitive.

The profitability spread and long term viability of the bank are the two aspects that need a very critical monitoring by the banks as well as RBI as regulatory authority. On one hand the borrowers are finding alternate ways of borrowing at competitive rates towards lower side. On the other hand depositors are finding alternate avenues for higher returns. This has trapped the banks at many times to take non-scientific and adhoc decisions. When there is imbalance between these in and out movements it leads to the asset and liability mismatch or gap. If the gap is more beyond tolerable level it may create liquidity problem and at some point of time may hit the viability of the bank. This may also results in inefficient use or deployment of resources by the banks. The managements of banks have to take decision on sound risk management to protect the interests of depositors and shareholders. Scientific calculation approach towards management of asset and liability reduces the risk involved, and ensures to large extent the soundness and viability of the bank. Due to this, the banks have to introduce effective Asset Liability Management (ALM) system to take care of liquidity, interest rate and currency risk.

All co-operative banks are advised to set up internal Asset Liability Committee (ALCO). The committee should be headed by Chief Executive Officer of the bank. The Board of Directors should oversee the implementation of the ALM system and review the functions of ALCO periodically.

With the acceptance of the recommendations of the Narasimham Committee on Financial Sector Reforms, the financial sector in India is undergoing a radical change. The deregulation of interest rates, introduction of prudential norms for income recognition asset classification and provisioning, reduction in CRR/SLR levels, capital adequacy norms, liberalized entry of new private sector banks and foreign banks etc. have brought the risk management function of banks to the fore. Banking in India stands transformed from the comfortable banking to one of dynamic interplay of market forces calling for a comprehensive management of the balance sheet itself. This has brought

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in the concept of 'Asset Liability Management' to the centre stage.

ALM is concerned with the strategic balance sheet management involving all market risks. ALM stands equated with total risk management i.e. liquidity risk, interest rate risk, exchange rate risk and credit risk. In other words, ALM can be defined as the process of managing the net interest margin within the overall risk bearing capacity of the bank.

A medium and long-term strategy of ALM involves assessing of risl-reward relationship of the assets and liabilities and thus the total balance sheet management. One instance where RBI addressed the problem of asset liability management to a limited extent was by introducing loan components in cash credit accounts for advances of over Rs.10 crore, as per Jilani Committee recommendations. The trend is towards phasing out the cash credit component.

Three pillars of ALM process

1.ALM information system

Management Information System

Information availability, accuracy, adequacy and expediency

2. **ALM Organisation**

Structure and responsibilities

Level of top management involvement

3. **ALM Process**

Risk parameters

Risk identification

Risk measurement

Risk management

Risk policies and tolerance levels.

Need of Asset Liability Management

- ALM units create a properly aligned risk and return management process. The right mix between skills and risk appetite must be identified, expected outcomes of activities known and appropriate metrics established. The approach adopted needs to be aligned to the realities of the market the bank.
- A bank needs to realize that the right level of asset and liability need to be committed to support the function.

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- Various techniques are used to examine the mismatch in a bank's balance sheet and it can be a difficult process if not supported with adequate systems. Depending on systems and analytical support the ALM process will undertake a number of analysis designed to identify; static and dynamic mismatch.

Significance of Asset Liability Management

Volatility

The globalization scenario has led to increase in number of economies. This has paved the way for market driven economies due to the changing dynamics of the financial markets. These changes are reflected in interest rate structures, money supply, and credit position of the market, exchange rates and price levels. Hence the organization experiences low market value, net income etc.

Product innovation

The innovation in financial products has grown rapidly. Some of the innovations are repacked with existing products with slight modifications. These have major impact on the risk profile in the organization enhancing the need for ALM.

Regulatory environment

The integration of domestic and international market has enabled the regulatory bodies of financial markets to initiate number of measures. These measures prevent major losses that occur due to market impulses.

Management recognition

The top management in the organization realized that asset liability is neither a franchise for credit disbursement nor it's a place for retail deposit base. It must be considered to relate and link the asset with liability. Hence the need for efficient asset liability management came into existence.

Categorization of assets and liabilities

The first step in ALM is to categorize the assets and liabilities broadly as under:-

- Permanent nature-assets and liabilities

- Long term assets and liabilities
- Medium term assets and liabilities
- Short term assets and liabilities
- Contingent assets and liabilities

1. **Permanent Assets**	**Permanent Liabilities**
Fixed assets Machinery Equipment Advance for lease of premises etc.	Capital Free Reserves etc..
1. **Long term Assets**	**Long Term Liabilities**
Long dated SLR investments Term loan – repayable in 3 years and over housing loans. Core cash credits	Deposits with maturity of 3 years and above Core amount kept in suspense A/c
Medium Term Assets	**Medium Term Liabilities**
Medium dated SLR investments Interest Accrued Other assets Medium term loans payable in 3 years	Deposits with maturity of 1 to 3 years core current a/c deposits Core SB Deposits
Short term Assets	**Short Term Liabilities**
Short dated SLR investments and Loans and advances Bills purchased	Short Term Depostis Call Deposits Non-Core SB Deposits Free Float Funds
Contingent Assets	**Contingent Liabilities**
LCs and Guarantees Forward Contracts Options Swaps	LCs and Guarantees Forward Contract Options Swaps

Risk Aspects

Liquidity Risk

Liquidity represents the ability to accommodate decrease in liabilities and to fund increase in assets. Liquidity is essential to compensate for expected and unexpected balance sheet fluctuations and to provide funds for growth. To the extent liquidity needs are met through holdings of high quality short term assets, the price of liquidity is the income sacrificed by not holding long-term and high yielding assets. The basic fact is that while excess liquidity would hurt long-term profitability, inadequate liquidity can lead to disastrous consequences.

Interest Rate Risk

It arises due to the changes in the general rate of interest, which in turn depends on inflation rate, regulatory policies, sudden changes in demand for and supply of money etc. for example, a five year fixed rate asset, if funded out of a two year equivalent liability would pose interest rate risk. At the end of two years, renewing the liability may prove costly if interest rates have gone up, thus reducing the net interest margin. Interest rate changes affect only income flows but also the value of permanent investments and hence the capital of the bank.

Credit Risk

Credit risk involves the risk that monies lent may not be repaid in time or not at all. Containment of credit risk in the case of a specific borrower is attempted by proper credit appraisal of the borrower, taking adequate marketable security etc. for the bank as a whole, prudential limit on individual and group borrowings, sector wise, industry wise, geographical area wise exposures are fixed. The capital Adequacy Ratio(CRAR) attempts to limit the credit risk of the entire advances portfolio with reference to capital.

Exchange Rate Risk

Exchange rate is the price of one currency in terms of the other. Under the free-floating exchange rate regime, these rates fluctuate at very short notice, sometimes even in a matter of minutes. The changes in exchange rates are prompted by the balance of payments positions, inflation differentials, interest rate differentials etc. between the two countries. These rates are also highly sensitive to political or economic and market news in the countries concerned. Above all, the

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demand and supply position of the currency also plays a major role in the fluctuation of exchange rates.

Conclusion

At the corporate level ALM involves.

- Managing CRR/SLR
- Developing, pricing and promoting new products.
- Devising schemes eligible for refinance to gain better leverage in managing asset and liabilities.
- Devising deposit mobilization and credit dispensation policies etc.

Asset Liability Committee (ALCO) spearheads these activities. CEO and other functional heads such as funds manager, treasure, forex dealer, officers in charge of advances and deposits, planning officer and MIS officer need to be the members of ALCO. This committee should be capable of formulating an opinion on market trends, interest rate movements, exchange rate movements and internal assessment of growth and financing needs. There can be sub-committees if required, for credit management, investment management, liability management etc.

Successful implementation of ALCO demands a very sophisticated and continuous supply of quality data from the operating units. Initially, the work involve in setting up a good ALM system. Once the system is established and stabilized, it will prove very useful to the top management in developing long-term growth strategies. Further deregulation in the coming years will make ALM a necessary tool without which it will be difficult to manage a bank.

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