CONCEPT AND TECHNIQUES OF ASSET- LIABILITY MANAGEMENT (ALM) – AN INDIAN PERSPECTIVE

Ronil K.Manohar, Research Scholar

Dept. of Commerce

Karnataka University Dharwad

Asset – Liability management is considered as risk management technique designed to earn an adequate return while maintaining a comfortable surplus of assets over liabilities . It is the act of planning acquiring and directing the flow of funds through a financial organization to generate adequate and stable earnings , maintain adequate liquidity and steadily build capital while taking reasonable and measured business risks. In short ALM is the sum of the financial risk management of any financial institution .(Christian A Cole and Allen FeatherStone -1997).

This Includes:

- Setting Policy
- Structuring of loan repricing and maturity schedules.
- Undertaking financial hedge positions
- Budgeting capital and
- Measuring internal profitability.

ALM also involves contingency planning and the analysis of the impacts of unexpected changes in interest rates , competition and economic growth. ALM is also concerned with understanding how individual business decision and aggregate portpolio composition affects a bank overall profile and how the bank should risk-adjust its performance (Uyemura, Dennis G and Donald R Van Deventer-1993). ALM is such a critical part of any financial institution's operations and its risk management , it is imperative that banks recognize ALM's importance and employ effective risk management procedures . In the absence of ALM techniques banks are insufficiently protected from ever changing financial risks and consequently find their profit ability jeopardized as did many banks in the late 1970s and early 1980s.

Evolution of ALM in Indian Banking System:

ALM process involve in identification , measurement and management of risk parameter The Reserve Bank Of India has in its guidelines asked the banks to use traditional techniques like Gap analysis for monitoring interest rates and liquidity risk. The RBI is expecting Indian Banks to move towards sophisticated techniques like duration , simulation and Value at risk in future. Most Indian private sector banks use Gap analysis for accrued portfolio. They are gradually moving towards duration analysis. Most of the foreign banks are using duration analysis. Some foreign banks are using advanced methods like Value At Risk for entire balance sheet .

ALM have evolved from early practice of managing liquidity on the bank's asset side to a later shift to a liability side. It came to be termed as a liability management. Later on it was realised for using both the asset as well as liability side of the balance sheet to achieve optimum resources management. This process was continued till 1970's. In 1980's volatality of interest rates in USA and Europe caused the focus to broaden to include the issue of interest rate risk . ALM began to extend beyond the bank treasury to cover the loan and deposit functions. The scope of ALM was further enlarged in later 1980's with introduction of credit risk into the issue of determining adequacy of bank capital. Earning a proper return on bank capital. Earning a proper return on bank equity and hence maximization of its market value has meant that ALM covers the management of the entire balance sheet of the bank. "This implies that the bank management are now expected to target required profit levels and ensure minimization of risk to acceptable levels to retain the interest of investors in their bank. This also implies that costing and pricing policies have become paramount importance in banks".(O P Chawala)

The equation of ALM to liquidity management by bankers in Indian prior to 1990 was due to regulated banking environment. There was no interest rate risk as the interest rate were regulated and prescribed by RBI. Spreads between deposits and lending rates were very wide. This spreads to more or less uniform among the commercial banks and were changed only by RBI. If a bank suffers significant losses in managing to its assets the same were absorbed by the comfortably wide spreads. The banks Balancesheets were not being managed by banks themselves. The balance sheets were being managed through prescriptions of the regulatory authority and the government. Now the banks have been given a large amount of freedom to manage their Balance sheets. However the RBI has suggested that bank should introduce ALM which would focus on liquidity management, interest rate risk management and spread management.

The ALM will continue to go a long way in managing mix , maturity, rate sensitivity , quality and liquidity of the assets and liabilities so as to earn sufficient an acceptable return on the portfolio (Soyonton Roy).

Asset- Liability Management Techniques :

ALM is bank specific control mechanism. Several banks may employ similar ALM techniques or each bank may use unique system.

Techniques for assessing asset- liability risk come to include gap analysis and duration analysis. These facilitated techniques of gap management and duration a matching of assets and liabilities.

Both gap and duration approaches worked well if assets and liabilities comprised fixed cash flows. However options such as those embedded in mortgages or callable debt posed problems that gap analysis could not address .Duration analysis could address these in theory, but implementing sufficiently sophisticated duration measures was problematic.

Gap Analysis :

Gap Analysis is a technique of Asset – Liability management . It is used to assess interest rate risk or liquidity risk. It measures at a given point of time the gaps between Rate Sensitive Liabilities (RSL) and Rate Sensitive Assets (RSA) (including off balancesheet position) by grouping them into time buckets according to residual maturity or next re-pricing period , whichever is earlier. An asset or liability is treated as rate sensitive if;

i.) Within time bucket under consideration is a cashflow.
ii.) The interest rate resets/reprices contractually during time buckets
iii.) Administered rates are changed and
iv.) It is contractually pre-payable or withdrawal allowed before contracted maturities.

Thus ;

GAP=RSA-RSL

GAP Ratio=RSAs/RSL

Gap analysis was widely used by financial institutions during 1980s . Gap analysis was used in tandem with duration analysis when it was used to manage interest rate risk . Duration analysis summarises with a single number exposure to parallel shifts in the term structure of interest rates.

Scenario Analysis :

Under the scenario analysis of ALM several interest rate scenarios would be specified for the next 5 to 10 years . These might specify declining rates , rising rates a gradual decrease in rates followed by sudden rise etc. Scenarios may specify the behavior of the entire yield curve, so there could be scenarios with flattening yield curve, inverted yield curves etc. ten or twenty scenarios might be specified in all . Next assumptions would be made about the performances of assets and liabilities under each scenario. Assumptions might include prepayment rates on mortgages and surrender rates on insurance products. Assumptions may also be made about the firms performance . Based upon these assumptions the performance of the firm's balancesheet could be projected under each scenario. If projected performance was poor under specific scenario the ALM committee might adjust assets or liabilities to address the indicated exposure . A short coming of scenario analysis is the fact that it is highly dependent on the choice of scenario. It also requires that many assumptions be made about how specific assets or liabilities will perform under specific scenario

Other techniques used for risk management relate to sensitivity analysis , simulation ,swaps ,hedging with financial futures, hedging with options etc.

Conclusion:

Asset – Liability Management is an important tool for monitoring, measuring and managing the market risk of a bank. With the deregulation of interest regime in India , the banking industry has been exposed to the market risk . Hence to manage such risk , ALM needs to be used so that the management is able to assess the risks and cover some of these by taking appropriate decisions.

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