Knowledge Sprint

Asset and Liability Management

This article is on Asset and Liability Management

It contains concepts like -

- Concept of Asset and Liability management
- Define ALM
- Objectives of ALM
- Evolution of ALM
- Reasons for Evolution of ALM
- Strategy of ALM
- Risks Managed by ALM
- RBI Guidelines for ALM process for indian banks
- Expected Questions for Exams and Interviews

Concept of Asset and Liability management :

- In short it is referred as ALM
- ALM, is one of the important tools of Risk Management used by commercial banks today.
- ALM is a comprehensive, dynamic framework that measuring, monitoring and managing the market risks of a bank.
- It deals with long-term management of risks like - variations in interest rates, foreign exchange rates, commodity price risks of a bank, liquidity positions of both banks and financial institutions.
- ALM is applied for credit risks and contingency risks.

Define ALM :

- ALM is a continuous process of - Planning, organising, and controlling the assets liability volumes, maturities, rates and yields.

Objectives of ALM :

- To protect Net Interest Income of a bank (NII).
- To Protect Net Interest Margin (NIM) or Spread of a bank.
- To Protect market value of net worth of a bank.

Evolution of ALM :

- The concept of ALM is of recent origin in india.
- ALM, got the significance post liberalization period of 1990's, due to drastic changes in financial sector.
- Reserve Bank of India, (RBI) evolved this tool in Indian Economy to manage the market risks of banks.
- It was introduced into Indian Banking industry by RBI with effect from 1st April, 1999.
- ALM is closed linked with Bank's business strategy.

Reasons for Evolution of ALM :

1. Volatility -

- Due to change in economic structure post liberalization, there was free flow of economies like money market and capital markets
- There were changes in interest rate patterns, money supply, credit supply, exchange rates and prices, that were subject to market demand and supply and created some volatility.
- In order to maintain, constant eye of these changes and keep them under control , RBI devised ALM mechanism.

2. Introduction of New Products -

- Banks started to come up with new financial products or modifying the existing products by adding a new featured
- This created a demand in market and proportionally, risks were also increased.
- Hence it necessitated to create a ALM concept by RBI

3. To create Regulatory Environment -

- Post liberalization has created a link that integrated domestic banks with international markets, thereby they were subject to market fluctuations.
- Therefore, new programs have been devised, to focus on management of assets and liabilities of bank to minimize the losses.
- According to directions from BIS- Bank of International Settlements, the global nodal agency for banks has suggested all central banks to develop a framework to manage the market risks of banks from market fluctuations.
- Accordingly, RBI took steps in this regards and developed ALM mechanism to manage credit risks of banks.

4. To have Effective Management of assets and Liabilities-

- It is noteworthy, to say that ALM is a step or framework to better manage the assets and Liabilities to minimise the risks.
- Having understood the benefits of ALM by top management of banks, they took serious steps to implement ALM in their operations.

Strategy of ALM :

1. Spread Management -

- Here the banks will maximise the Spread Management that is NIM.
- This is done by identify the risk exposure of cyclic rates, reduce such exposure to cyclic rates.
- There by banks can stabilise the earnings.

2. Gap Management -

- It is balancing the gap between interest sensitive assets and interest sensitive liabilities by distributing the assets and liabilities into various time bands.
- These time bands are called as “Buckets”
- The buckets are distributed based on their maturity period.
- Here Interest sensitive assets and interest sensitive liabilities means, those assets and liability are impacted by changes in interest rates of market.

3. Interest Sensitivity Analysis -

- Here the banks will study the impact of changes of interest rates on banks - NII and NIM.

Risks Managed by ALM :

1. Interest Rate Risks.

- ALM helps to manage risks of all types of Interest rate risks like - gap risk, basis risk, embedded option risk, yield curve risk, reinvestment risk

2. Liquidity Risk

RBI Guidelines for ALM process for indian banks :

- RBI, had formulated guidelines which are helpful for effective management of assets and liabilities.
- The guidelines are applicable for measuring liquidity risks and interest rate risks.
- It involves three process, they are -

1. Information ALM
2. Organisation ALM
3. Process of ALM

Let us study each of them ...

1. Information ALM -

- Here information plays a vital role that specifies about risk involved.
- Banks should be in position to evaluate exact details of all assets and liabilities that come under purview of market risks.
- Based on informational analysis, and its accuracy further steps can be applied.

2. Organisation ALM -

- It tells that all ALM decision making systems should be under top level management.
- Every bank should create a proper structure of top management to handle ALM
- Generally, Asset Liability Committee (ALCO) is responsible for implementing by ALM in banks.
- ALCO is headed by Chief Executive Officer (CEO) of that particular bank.

3. Process of ALM -

- It focus on Asset Quality, Evaluate the risk and its management.
- For the purpose of Evaluation, a bank may undertake below activities -
    - Manage Liquidity risk
    - Manage Market risk
    - Plan for funding and capital
    - forecast growth and profitability etc.

Expected Questions for Interviews or Exams -

For Exams -

Q. Discuss about ALM and its Evolution in India?
Q. Discuss about role of ALM in Risk Management?
Q. Write in brief about RBI guidelines on ALM for Banks ?

For Interviews -

Q. what do you mean by ALM ?
Q. Expand NII and NIM ?
Q. What are risks managed by ALM ?
Q. Who is regulator of ALM in India ?
Q. What is role of ALCO in ALM?

Thank you

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