CHAPTER – VIII

CHAPTER - VIII

DECISION MAKING & IMPLEMENTATION OF ALM

- **INTRODUCTION**
- **SITUATIONS FOR DECISION MAKING**
  - DECISION MAKING UNDER CONDITIONS OF CERTANITY
  - DECISION MAKING UNDER CONDITIONS OF UNCERTAINITY & RISK

- **ALM IMPLEMENTATION**

  - MACRO & MICRO LEVEL ALM
  - GUIDELINES GIVEN BY RBI FOR EFFECTIVE IMPLEMENTATION OF ASSET-LIABILITY MANAGEMENT SYSTEM IN BANKS
    - ALM INFORMATION SYSTEMS

DECISION MAKING & IMPLEMENTATION OF ALM

Introduction:

In view of the asset-liability transformation commercial banks are generally exposed to various risks like credit risk, market risk & operational risk. However, with a recent wave of liberalization in various sectors of the Indian economy coupled with integration of domestic markets with world markets, the risks associated in banking business have become complex and large, requiring strategic management. Banks are now operating in a deregulated environment and are therefore required to determine on their own, interest rates on deposits and advances in both domestic and foreign currencies on a dynamic basis. The interest rates on banks' investments in government and other securities are also now market related. Intense competition for business involving both assets and liabilities, together with increasing dynamism in the domestic interest rates as well as foreign exchange rates, has made management of banks to maintain a good balance among spreads, profitability and long-term viability. Imprudent liquidity management can put banks' earnings and reputation at great risk. These pressures call for structured and comprehensive measures and not just ad hoc action. The management of banks has to base their business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy.

As said earlier, banks are exposed to several major risks in the course of their business like credit risk, interest rate risk, foreign exchange risk, liquidity risk, operational risks etc. Hence, banks introduce effective risk management systems that address the issues related to interest rate, currency and liquidity risks etc. in banking business under the competitive financial environment. It is for the top management of the bank which has to decide as to how these risks will be taken care of, which technique would be applied and when should this be applicable. This gives rise to different situations where in top management of a bank has to take important decision regarding various risk managements.

Situations for Decision Making:

Decision making is one of the most essential part of management in every commercial bank. This process becomes complicated for two reasons:

(i) At the time of taking the decision, the consequences are either unknown or are not very clear as all the decisions pertain to future events. and

(ii) The sufficiency and accuracy of the inputs required for the decision making are not known in prospective but are available in retrospective only.

The primary conditions for an objective approach to decision making are as follows:

- Availability of alternatives from where selection be made,
- Consequences for each alternative be identified, and
- Consequences be quantifiable

The decision making process gets complicated by the need for forecasting. Generally, there are two conditions of decision making; viz.

Decision Making under Conditions of Certainty:

If the commercial bank knows with certainty that there might be an increase in the interest rates, then it might decide to go in for fixed interest rate instrument. This decision is easy since the outcome is known with certainty. However situations of certainty under deregulated/competitive environment are rare in real life.

Decision Making under Conditions of Uncertainty & Risk:

As said earlier, no one can predict the future under competitive financial environment with certainty. However, it is always possible to visualize few situations that might prevail alternatively. A certain probability can then be assigned by the commercial bank for the occurrence of each alternative to take the decision. However the range of probabilities would lie between the subjective assignments based upon the opinion of the decision maker and the objective assignments based on past data performances.

Risk is defined as a measure of the variability present in a situation - Like any other business concern, a commercial bank is primarily concerned with the risk which, impact its profits. One of the most important aspect of risk in banking business is the prevalence of positive correlation between risk and returns. In other words, higher the risk higher will be the returns. If a commercial bank is inclined towards higher returns, it may have to take greater risks. Hence, the commercial bank has to first decide about its risk-return preference and then take decisions accordingly. However, identification of the risk-return preference & taking decision based on the same, are both difficult tasks. It is at this juncture the risk management tools actually help the bank in safe guarding its interest. Hence, ALM which is an invariable part of the risk management should be implemented effectively by banks.

ALM Implementation

As discussed earlier, on the Recommendations of Narsimham Committee, the Financial Sector Reforms in the last decade of the bygone century brought unprecedented changes in the field of banking & finance. Opening up of the various financial markets, Interest rate deregulation in conjunction with the stiff competition etc. began affecting the spreads of banks. Similarly, the pressures on the liquidity, profitability and sustainability of a bank cannot always be tackled with objectivity at the eleventh hour. Hence, it is advisable that whenever banks are dealing with the aspects related to the interest rate/exchange rate fluctuations, liquidity positioning, credit accommodation, etc. they should take a strategic perspective. This means, banks should first of all understand the risks that have to be taken in order to gain the rewards that are set as the target.

In fact, commercial banks except regional rural banks (RRBs)in India are required by RBI to introduce effective risk management systems on priority basis. RBI as regulator of commercial banks in India has been providing comprehensive guidelines from time to time to banks so as to achieve consistency and transparency in annual balance sheet in line with established international practices. The details of these guidelines provided to banks are available in Master Circular on Prudential Norms On Income Recognition, Asset Classification and Provisioning pertaining to advances issued in July 2004 this is available on central bank's website also. RBI has also issued a final set of guidelines effective from 1/4/1999 for the introduction of ALM systems as a part of the over all risk management and control systems in banks. They are intended to form the basis of initiating collection, compilation and analysis of data required to support the ALM system. We cover here the RBI prescribed risk management frame work for effective implementation in banks. Considering this fact the study, now takes a deep insight into the implementation part of ALM, highlighting the role played by the various levels of managements in this process.

Macro-and Micro-Level ALM

The various risks in banking business are managed at both the macro-level and micro-level. The macro-level risk management provides a risk management framework for the bank and hence the decision makers comprises of the top management including members of Board of Directors. The latter i.e. the micro-level business decisions is taken by the middle management. The middle management comprises of business managers who have an interface with the bank's corporate & individual customers & closely monitor the competitors in the market.

At the macro-level, broad guidelines are drawn so as to enable the middle management at micro level to take decisions relating to individual proposals for investment and borrowing without the involvement of the top management on a day-to-day basis.

Under the RBI guidelines on ALM the macro-level management of risk is conducted by the Asset-Liability Management Committee (ALCO), which comprises of senior management including CEO of the bank. ALCO is responsible for the product pricing for both deposits & advances based on current & future business strategy of bank eg. ALCO takes its decision on future interest rate movements, the mix of Wholesale vs Retail deposits, accommodation of credit mix exposures in various business sectors in domestic & foreign currency etc. At the micro-level, the business managers carry out risk management exercise independently. These business managers base their investment and borrowing decisions on the ALCO recommendations.

GUIDELINES GIVEN BY RBI FOR EFFECTIVE IMPLEMENTATION OF ASSET-LIABILITY MANAGEMENT SYSTEM IN BANKS:

As said earlier, RBI in its guidelines has made it necessary for commercial banks to address various risks involved in the business of banking in a structured manner by upgrading their risk management systems and adopting more comprehensive ALM practices. ALM, among other functions, is also concerned with risk management and provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity, interest rate, foreign exchange etc. risks of a bank that needs to be closely integrated with the banks' business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.

The ALM process rests on three pillars[1]:

1. ALM information systems
    - ⇨ Management Information System
    - ⇨ Information availability, accuracy and expediency
2. ALM organization
    - ⇨ Structure and responsibilities
    - ⇨ Level of top management involvement, and,
3. ALM process
    - ⇨ Risk parameters
    - ⇨ Risk identification
    - ⇨ Risk measurement
    - ⇨ Risk management
    - ⇨ Risk policies and tolerance levels.

ALM Information Systems & Organisation

ALM has to be supported by a management philosophy which clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary information system as backup. Thus, information is key to the ALM process. However, due to varied business profiles of banks in India the adoption of a uniform ALM system for all banks do not make feasible. There are various methods prevalent world-wide for measuring risks. These range from the simple Gap Statement to extremely sophisticated and data intensive Risk Adjusted Profitability Measurement (RAPM) Methods. The central element for the entire ALM exercise is the availability of adequate and accurate information as regulators have prescribed stringent capital adequacy and other norms for market risks. A prerequisite for this is that banks must have in place an efficient information system for risk measurement & monitoring. RBI in its final set of guidelines have suggested to banks that process of adoption of ALM be addressed, by following an ABC approach, i.e. analyzing the behaviour of asset and liability products in the top branches accounting for significant business and then making rational assumptions about the way in which assets and liabilities would behave in other branches and, in respect of foreign exchange, investment portfolio and money market operations, in view of the centralized nature of the functions, it would be much easier to collect reliable information. The data and assumptions can then be refined over time as the bank management gain experience of conducting business within an ALM framework. Further, RBI stresses in the guidelines that the spread of computerization will also help banks in timely accessing data & information.

At the macro level the ALCO is a decision making unit in the bank consisting of selected people from senior management responsible for total balance sheet planning from risk return perspective including the strategic management of Interest Rate, liquidity and other risk, whereas at the micro level it has an ALM support group consisting of business managers other staff who are responsible for quantifying monitoring and reporting the risk profile under the emerging competitive environment to the ALCO.[2]

With the implementation of ALM in most of the banks, time is ripe to undertake a comprehensive examination of performance of banks under ALM regime to provide clues to understanding and assessing the risks in banking business under the market driven environment. In the next chapter, the study analyses various aspect of ALM with reference to Liquidity Risk and Interest Rate Risk position of purposively selected commercial banks.

Conclusion

To sum up, while there can be no unknown risks that can arise in the banking business, it is essential that a bank remain alert to the events that affect its operating environment and react accordingly in order to avoid any undesirable risks. This signifies the role of ALM, which primarily involves the identifying, understanding and the managing of risks. ALM presents a more disciplined decision making framework for banks while, at the same time, guarding the risk levels. Clearly, then, a good foundation for such a process requires efficient and effective human and technological infrastructure. This will further lead to a smooth integration of the risk management process with the bank's business strategies.

References:

1) **www. rbi.org.in**
2) **www.almprofessional.com**