CHAPTER-V

PROBLEMS AND SUGGESTIONS TO IMPROVE ASSET LIABILITY MANAGEMENT

The conceptual background of ALM and Risk Management in banks, the responses of bank on ALM practices and magnitude of Interest rate risk and liquidity risk of banks under study were discussed in Chapter I, III and IV, respectively. The discussion in these chapters revealed that managements’ of banks under study have given considerable importance post 1999, to the ALM. The study reveals that there is a segment of banks which has adopted sophisticated practices but, alongside, there are a number of banks, still using traditional and naive practices. The discussion also reveals that the banks under study (representing Indian banking sector to a large extent) carry low/medium liquidity risk due to large government securities holdings but majority of these banks have significant interest rate risk exposure. So, we can say that the previous chapters of this study have revealed that ALM of banks under study meet the regulatory criteria which has led to reasonable sophistication in practices and has also lent stability to the Indian banking industry. However, there are problems inherent in the system adopted by banks. Which rests on three pillars (a) ALM information system, (b) ALM organization and (c) ALM process

PROBLEMS IN THE ALM SYSTEM OF BANKS

(a) ALM Information System

(1) ALM information system is the most important pillar of banks’ ALM. It says that information is the key. Indian Banks have either completed the computerization process recently or are
in the process of completing it. What has proved a constraint for effective ALM, is either the banks do not possess the data or they do not have access to analyzable data. As Information is the key to an efficient ALM system, the lack of data and information is a ferocious challenge before banks.

(2) Banks in India do not have a very long past of computerization. Majority of the banks have either completed full computerization recently or are in the process of completing it [only 85.6% of the Public Sector Banks have fully computerized branches as on March 31, 2007]* with the continuous expansion in number of branches. The greatest challenge which banks are facing is lack of IT infrastructure in terms of computerization. Lack of computerization is adversely affecting the ALM of a bank.

(3) RBI requires banks to collect, compile and submit information as compliance function on credit risk, market risk, ALM, Operational Risk, Risk focused internal audit, etc. With the introduction of Based II norms, Indian banks’ present status of MIS will not serve the purpose. The situation is not that bad in private sector banks; most of the times, they grapple with desparate and disconnected system. The problem is aggravated by universality of services in banks.


(b) ALM Organisation

(4) All employees working in the banks are not aware of nitty gritty of ALM and risk management. The situation is not very poor at the top level but at
the regional, and branch levels, the awareness level of employees is very low rather negligible.

(5) The results of study highlight that all the banks responding to the questionnaire benchmark the acceptable level of risk in case of liquidity risk. Regarding the acceptable level of risk, majority of banks mentioned the level prescribed by RBI as their benchmark, a few of the banks reported setting internal limits for the risks. This situation ultimately raises an issue that “Are banks still considering ALM as an ‘add-on’ in business planning and management”? Is it used as a tool to meet regulatory criteria laid down by RBI? If the answer is ‘Yes’ then this issues may emerge as critical problem in the context of transition to Basel II.

(6) As per the concept, ALCO is a decision making unit responsible for balance sheet planning from risk-return perspective including the strategic management of interest rate risk and liquidity risk. But the same has not emerged from the study. The study reveals that ALCO is largely playing the role of a monitor (58.3%). 41.7% of the banks reported disseminating role being played by the ALCO. Only 25% of the banks reported ALCO playing a role of figure head and leader. Resource allocator, disturbance handler and Negotiator were the next common roles played by ALCO. This clearly shows that management has continued to prefer not to see the actual importance and use of ALCO to the ALM of the bank. This is a problem which has restricted ALCO playing a very limited role, for example: sometimes only monitoring the interest rates. This issue has also created confusion in the mind of bank personnel with regard to “ALM” as to it belonging to whom.” During the personal visits made to the bank offices, officials were seen dabbling with this issue of ‘ALM belongs to whom i.e., whether it belongs to finance department, treasury department or risk management department or ALM department or ALCO of the bank.
Profound changes have taken place on the front of ALM. A common problem before each bank operating in India is the dearth of risk expertise in the country.

(c) ALM process

Existing Interest rate risk regulation that requires bank to keep 5% of its investment portfolio held on its trading account as Investment Fluctuation Reserve (IFR). It is not appropriate [as per this regulation, two banks having same government of India bonds portfolio will hold the same amount as reserve]. It does not give recognition to the fact that two banks do not have the same risk profile.

In terms of instruments available to banks for hedging the risk, the situation for banks in India seems to be one of inadequacy. On comparison with other countries, it may be noted that banks in India have limited instruments which could be used for hedging risks. However, there are certain instruments which are available but can be said to be practically unavailable rendering the instruments useless. In the ever changing banking environment, the most crucial issue at present is – Limited number of instruments available to hedge risk.

GENERAL PROBLEMS.

The results of the study reveal that mainly the focus of liquidity risk policy (91.7%) and interest rate risk policy (75%) is management of the risk whereas 50% and 58.3% of the banks reported reporting of the risk as the focus of IRR policy and liquidity risk policy, respectively. This clearly shows that there is a good stress on managing and reporting of risk but quantitative analysis of risk is not too good. This problem has a manifold effect as risk identification and measurement if not done properly and
periodically leads to — (i) a vague outlook of risk profile (ii) requirement of more financial and expert human resource for managing risk. (iii) it sometimes forces banks to window-dress the financial statements to reflect a healthier picture. So, the banks must view lesser focus on quantitative analysis (risk identification and measurement) of risk as a problem for the banks’ ALM.

(11) The structure for the ALM has been laid down in RBI guidelines on ALM. It has emerged from the study that banks under study meet the regulatory criteria laid down by RBI. To the extent that this is a critical function, it is inevitable that banks must build a dedicated structure that leads to sophistication at all levels. The study had brought forward a point reflecting absence on the part of banks about the independent and continuous performance evaluation. Also, only half of the responding banks indicated conducting peer group comparison relating to IRR and Liquidity Risk, which can act as a platform for adopting sophisticated practices. All this can prove to be a constraint for the banks to adopt better practices.

(12) Majority of the banks under study have mentioned conducting training programme as and when required which means an absence of definite and defined training programme. From this, we can conclude that banks have continued to prefer not to see the importance of training in its proper perspective. Lack of proper training limits the optimum utilization of human resources for ALM function. It also limits the use of technology for ALM functions. As has been seen in the study that software is being mainly used in banks under study for risk monitoring and reporting. However, balance sheet structure, risk measurement and risk treatment are equally important functions of ALM.
A serious threat to the survival and success of a bank is uncomfortably high level of NPA'S. It prevents recycling of funds resulting in erosion of capital and profitability of the banks thereby affecting the ALM performance of a bank.

Apart from these problems/Challenges, Indian banks may face greater problems due to further opening up of banking sector (Post 2009) and if India adopts full capital account convertibility (Amadou Sy). The problems that will emerge are-

1) Banks will be exposed to newer risks and new dimensions of existing risk.

2) Banks will be exposed to larger amount of IRR.

3) Liquidity risk of banks will undergo a change due to the positions in foreign currency denominated assets and liabilities.

4) Fluctuations in liquidity position will happen due to large and uneven flow of funds, etc.

5) New dimensions of credit risk will get incorporated.

Changes can be suggested in the existing ALM practices to remove above mentioned problems and weaknesses and improve and tone up the ALM system of banks. Also, there are constant changes taking place in the banking environment warranting the need for more sophisticated practices and a close look at magnitude of risks. Consequently, an ALM system must be constantly reviewed for its ability to meet the objectives of the bank. A successful and effective ALM system requires changes at three
levels viz. the ALM information system, ALM organization and ALM process.

**SUGGESTIONS TO IMPROVE THE ALM SYSTEM OF BANKS**

1) ALM information system

   a) Information is the key to ALM process. The performance of ALM system of an organization is affected by the non-availability and inaccuracy of data often resulting in sub-optimal decisions. So, in order to improve ALM of banks and to create an appropriate environment for accurate information, banks must set up data warehouses and data banks.

   b) A robust MIS must be put in place by the banks that generates information with five elements-timeliness, accuracy, consistency, completeness and relevance.

2) ALM Organisation

   i) ALM policy must be fully understood by the top management. An insight into the policy must also be given to the other levels of management. This can be done by providing policy document or a brief summary of the policy to all branches of bank.

   (ii) The policy must not only include what is being done at the moment rather what all must be done by the bank.

   (iii) A benchmark policy/manual should be adopted to help in effective ALM.
(iv) The roles and responsibilities of each key individual must be clearly written and defined.

(v) The concept of gainful utilization has to be achieved. ALCO must play a wider role.

(vi) The chain of command for various activities must be clearly defined and written in the policy.

(vii) It is necessary for the commercial banks to induct specialists in the area of risk management like risk managers, in the bank who can guide and lead the risk management system of banks on sound business lines. In fact, banks should set up a new profile of Chief Risk Officer.

(viii) The banks for better management of risks (ALM), may think of bringing up a change in organizational set up with respect to ALM. A typical organizational set up for effective ALM may be-
3) ALM PROCESS

A) Liquidity Risk-

(i) Banks must monitor liquidity at the head office level. A lot of importance should be given to mismatch of less than one year.

(ii) Liquidity position must be reviewed for each currency individually.

(iii) Banks must think of setting up emergency teams for handling liquidity crisis.

(iv) Banks must have a definite plan to handle liquidity crisis and liquidity needs of the bank.
Problems and Suggestions to Improve Asset Liability Management

(B) Interest Rate Risk-

(i) More attention should be given to the IRR exposure of the bank. Banks should use more instruments. Also, government/RBI should introduce new instruments for hedging of risk.

(ii) Majority of the banks under study exhibit a significant IRR. Therefore, it is in the interest of the bank to take appropriate steps e.g., set up internal limits on IRR exposure etc.

(iii) There is a good stress on reporting of risk profile but quantitative analysis of risk is not so good. In order to improve the situation, banks must put in place a proper framework for measurement of risk, especially IRR.

(iv) Banks should be asked to maintain a reserve based on the amount of interest rate risk held on the balance sheet rather than being asked to maintain a certain percentage of investment portfolio held on their trading account.

In addition to all these suggestions, the following measures may be implemented by banks to tone up the efficiency of ALM system of banks—

(i) All the employees working in the bank must be provided awareness about ALM and Risk management. Training and management development efforts in specific areas of ALM and risk management must be undertaken. Also, appropriate programmes should be designed and initiated to create an informed work force. Training days per person have to be adequately defined and actually adhered to. It is important because the constituents of a bank need to understand the
concept and importance of ALM and Risk management to help the bank in facing the challenge from foreign and global banks.

(ii) Independent and continuous performance evaluation is essential for improving the practices and status of ALM in India. So, every bank should set up a research wing which should evaluate the performance of ALM policy, ALCO, etc. and should highlight the weaknesses, if any, in the various spheres of banks' ALM. It should not be considered as a fault finding exercise but a continuous effort for ensuring achievement of financial objectives, bank stability and overall improvement in ALM system of the banks. This should further be complemented by peer group comparison and comparison with best global banks. Banks also need to adopt some benchmarking mechanism.

(iii) Independent and outside research work is important for the development and growth of ALM and Risk management among banks. So banks/government/RBI should give priority to evolve a Risk Management Institute. The Institute can aim at providing information and education by way of educational programmes, seminars, workshops, talks, experiences of bankers, training programmes, etc. which will help in reducing the dearth of risk expertise. Since this will be useful to the banks and the industry as a whole, every bank should encourage and participate actively in the activities of institute. Further, the giants in the industry must contribute a small percentage of their profits to the Institute for its proper functioning.

(iv) Mounting over dues is a chronic constraint confronted by the banks. It prevents recycling of funds resulting thereby in eventual
erosion of capital base and profitability of these banks. Banks should work towards bringing down the level of overdues/NPA’s.

(v) It would be a good idea to adopt a national level award, based on ALM and Risk management practices and performance of a bank. In order to encourage the Indian banks to adopt international practices, the jury of such award may be drawn internationally.

(vi) Tarapore Committee Report has recommended a number of measures for banks to undertake, this will help banks’ to face challenges from outside and specially of full capital account convertibility. The report recommends-

(a) Banks should monitor their liquidity position at the head/corporate office level on a global basis, including both the domestic and foreign branches.

(b) RBI should think of linking up the open position limits to banks capacity to manage foreign exchange risks as well as their unimpaired tier I capital.

(c) RBI should put in place a robust accounting framework, a robust independent risk management framework in banks, comprehensive guidelines on derivatives, appropriate and adequate disclosures, etc.