JETIR.ORG ISSN: 2349-5162 | ESTD Year : 2014 | Monthly Issue

JOURNAL OF EMERGING TECHNOLOGIES AND INNOVATIVE RESEARCH (JETIR)

An International Scholarly Open Access, Peer-reviewed, Refereed Journal

# ASSET LIABILITY MANAGEMENT IN BANKING AND FINANCIAL INSTITUTIONS.

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**Abstract:**

Asset and Liability Management (ALM) plays important role in finance and banking industries. Any bank or financial institute will not succeed without the use of ALM strategies. So, for existence and to compete in the market, the Asset Liability analysis is done by the finance and banking to measure the value of various risk factors involved. ALM analysis not only minimizes the risk of various factors but also it helps to achieve to reach the goals of these industries. We are going to do a study of various ALM techniques stated in various literature, pointing to financial strength. This study helps for developing banks to adopt the different ALM techniques used by the finance and banking industries and to select the effective technique out of the stated techniques.

**KEYWORDS:** Asset Liability Management, ALM, Banking, Financial Institution

## 1. INTRODUCTION.

The ALM is defined as "managing both assets and liabilities simultaneously for the purpose of minimizing the adverse impact of interest rate movement, providing liquidity and enhancing the market value of equity. It is also defined as “planning procedure which accounts for all assets and liabilities of a bank by rate, amount and

maturity." In short we can say ALM is a process of planning, organising and controlling various risks associated with the bank. ALM is the management of all financial activities of the bank, in short we can say management of Balance sheet of the bank. Banks are facing various risk involving in its activity which consists Market risks, capital risks, interest risks, credit risks, liquidity risks etc. ALM plays important role to manage all these risks. For managing these risk commetee is framed which called Asset Liabiltity commeetee (ALCO). In this commeetee top most employees on the institute are there like, CEO, Board of directors etc. And the responscibilty to run ALM properly is taken by them.

Many scholars had done significant work related to the ALM. Basel Committee was one of the crucial motivators of Asset Liability management. In 1988 the Basel committee was established by the central bank governors of 10 countries to supervise banking activities. The committee has given instructions to banks for the minimus requirements of the capital which were known as Basel I. They have mainly focused on risk associate with the Credit. After that in 2004 more instructions were introduced as Basel II for capital adequacy and Risk Management. 2008 global financial crisis occurred which was due to fail the Basel II norms and therefore Basel III were suggested in 2010. Their main objective was to boost more flexible banking system. They have focused on four main banking principles that is Capital, leverage, funding and liquidity.

**2. Types of Risks involved in Asset Liability Management.**

Risk means a chance or probability of a loss or damage. Every activity has risk to get failed or having loss or damage in result. In term of banks various risks are there in banking activity such as capital risk, credit risk, interest rate risk, market risk and credit risk. These types of financial risk require emphasis as banking industries have quick changes in their working environments. Banks has to understand it and do their banking activity by considering such risks.

**1. Capital Risk**- in any business the most important is to have adequate capital to run a business smoothly. In banking practice the maintenance of sufficient capital is required. There is huge requirement of standardization in international practices which tries to make banking practices common all over the globe. Capital adequacy also focuses on the weighted average risk of landing and up to that extent, banks can identify its positions between more risky and less risky portfolios and can readjust their position.

**2. Credit risk-** Management of Credit is very important thing for the organisation as it involves the risk. Sometimes debtors are not able to pay payment obligation on time. The failure of payment may lead to failure of banks. Another important problem is contract execution in countries like India. Law developments are very essential to meet timely contract execution. If there are loopholes and delays in law development systems it may affect the ability and willingness of the lender to execute the contract. There are many cases pending in courts. The Law has to work properly and timely the judgments should be given and clear the pending cases. Due to

this rate of return is very weak. It is also affects to the market risk. So that it is very essential for the banks to focus on lending practices and credit assessments to change the scenario. Due to lack of proper financial information credit risk calculations becomes more complicated. Thus Credit risk management is very important thing for the Banks.

**3. Interest Rate Risk.-**Interest rate risk means the change in price of bonds due to change in rate of interest. Today it is consider as serious because interest become more unstable. Before 90s the government used to get money as borrowed loan from banks and financial institutions. The rate of interest was between 4.5% to 8%. Fluctuation was adverse as smaller the rate, higher the fluctuation. Due to
artificially fixed low rates, banks confronted adverse situations when the interest rate structure was relaxed to bring into line with market rates. India has significantly more issues associated with risk of interest rates, which is because of situations outside its control. Thus it is desired to handled
the risk properly and to accept innovative techniques to encounter these challenges
faced by various financial institutions.

There are some measures to measure the risk of rate of interest.

a. Maturity- The time period of payment final principal amount is called maturity. The maturity time is longer the risk involved in more and shorter time of maturity the risk would be lesser.
b. Duration- Duration can be used to know the sensitivity of prices to changes in interest rates. It represents the percentage change in value in response to changes in interest rates
c. Dollar Duration- Characterizes the actual dollar change in the market value of a holding of a security in response to percentage change in rates.
d. Convexity- Because of change in market rates and passage of time duration maybe not remain constant.

**4. Market risk**:

Market risk is related to financial condition, which significances in adverse movement in market price. When there is a significant rise in the term structure of interest rates or violent fluctuations in the rate structure, one finds considerable demolition of the value of securities held.

**5) Liquidity Risk**:

It is probable incapability to generate sufficient cash to manage with decline in deposits or rise in assets. It is because of mismatch in the maturity pattern of assets and liabilities.

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