Assets-liabilities management

Business, Management

Assets-Liabilities Management Name: Institution: Assets-Liabilities Management Introduction Primarily, assets liabilities management or ALM involves managing risks that normally arise from mismatching liabilities and assets in a bank. However, this scenario can also appear in the field of insurance. Banks have to deal with numerous risks including operational risk, credit risk, interest rate risk, liquidity risk among others. In particular, liquidity risk involves the inability of raising sufficient cash needed to managed asset and deposit increase or decrease. Hence, asset liability management is a tool for managing these risks for banks and financial service corporations and companies. The process of risk management in asset liability involves matching the liabilities and assets in accordance with the maturity pattern by securitization and hedging.

Even though credit risk management is a challenging practice, failure to apply poses the risk of bank failure. Assets Liabilities Management The major relevance associated with assets liabilities management has led to scholars putting forward a number of definitions depending on the context it is applied. ALM is applied in a context that relates to the organization’s policy of managing its books of accounts with the intent of facilitating liquidity scenarios and alternative interest rates. Banks and other financial corporations engage in activities that expose them to various risks such as liquidity and credit risks (Bessis, 2002). However, ALM works to protect these institutions from succumbing to such risks and allows them work under reasonable risk levels. Additionally, ALM plays the role of enabling banks and financial institutions to stay secure in events of risks. Ultimately, the ALM approach is a fundamental factor that facilitates the long-term strategy of

financial institutions for tackling interest margin ratio and net economic value. The diverse approaches of managing a corporation’s statement of financial position relates to planning and regulating the blend, level, and changes in assets, capital, and liabilities.

For example, banks in the early 19th century used this approach and achieved high demand deposits and savings. In this period, banks worked by building up mechanisms that fostered effective utilization of these resources because of the low costs of deposits. Hence, these banks focused mainly on managing their assets. In time, however, the costs of low cost funds have declined. This has led to the management of liabilities undertaking a different approach.

This approach involves using federal funds, commercial paper, and cumulative deposits when purchasing money. This aspect of liability management is crucial because it provides resources for that finance profitable loan opportunities. According to Bessis (2002), even though the volatility of rates has increased and the economy damaged by economic downturns, banks turn to this approach of asset liability management to provide better economic conditions. Risks Emanating From Mismatch Ultimately, mismatching between assets and liabilities creates numerous risks. In this regard, a risk coming from this form of mismatch includes liquidity risk, market risk, credit risk, interest rate risk, and capital risk.

Capital risk in this case is the risk that a bank may lose a given amount of money from an investment. For instance, a bank undertakes capital risk whenever it makes an investment. For instance, if the bank invests an

amount of 100, 000 dollars, the maximum loss it can incur will not exceed that amount. However, this does not apply when the investment is made on risk free security. Interest rate risk, on the other hand, involves changes in bond price that are caused by changes in interest rates. Langen (2009) maintains that the interest rate risk is in a way a bank's blood pressure. It can decrease or increase without any warning signs and such differences can lead to failure. However, banks and financial institutions can monitor it and act accordingly by taking preventing steps for managing it.

However, banks do not work to eliminate it. This is because it is necessary for survival just like blood pressure. The other type of risk that results from asset and liability mismatching is the credit risk. This type of risk results when parties that owe bank money fail to pay up on the stipulated date.

Although managing this kind of risk is challenging, failure to consider it can lead to a back having most of its money tied up hence hampering its operations. Market risk implies a financial situation that results from adverse movement of market prices. In particular, this risk prevails more when financial data is attained from conducting a market-to-market approach. The reason behind this is that fluctuations in assets pose severe effects on the bank's balance sheet. Liquidity risk is another risk that results from asset liability mismatching. This risk results from the failure to generate sufficient cash required to manage an increase in assets or decrease in deposits. This mainly includes the results of mismatching maturity patterns of assets and liabilities.

The reason behind this is that security with long-term maturity bear greater volatility in case of changes in the interest rate. Model Use Models used in the management of asset liabilities allow banks and other financial institutions to measure and monitor risks. It also provides appropriate avenues that can be used to manage financial risks. One such model is the gap analysis model that is designed to measure the direction and degree produced by the mismatch between liabilities and assets using the funding or maturity gap (Kosmidou and Zopounidis, 2004). This model can be applied for assets and liabilities that exhibit different periods of maturity. Hence, computation is conducted at a given period. In particular, this model stresses on a bank’s exposure of net interest income against changes in interest rates.

Re-pricing gaps are calculated for assets and liabilities on different maturity levels. Positive gaps indicate that assets have undergone re-pricing first followed by liabilities. A negative gap, on the other hand, shows that liabilities undergo re-pricing first then followed by assets. Banks and financial institutions evaluate the rate of sensitivity of every asset and liability from the corporation’s statement of financial position. The rate of the sensitivity requires a manager to wait the stipulated time before changing the rates posted on any asset or liability (Risk Books and Kamakura Corporation, 2008).

Even though alterations in the rate of interest may affect the market value, it limits the model by solely considering the book value of liabilities and assets and disregards their market value. The other model applied is referred to as

the duration model. This model plays the role of measuring sensitivity rates related to liabilities and assets. In this case, duration relates to the average life of the asset or liability. This model is beneficial in the sense that it utilizes the market value of the assets and liabilities. The risk value of this model reflects the maximum loss a bank expects incur in a particular period. This model allows banks to calculate their market risk and their net worth. This facilitates focusing on implications of future decisions and long-term risks.

The third model is referred to as the simulation model. This model incorporates the dynamic aspect of assessing interest rate risk. The gap and duration models, however, have limitations due to exposures to rate of interest risk. Corporate & Commercial Loans as a Protective Instrument The model of re-pricing is used widely in facilitating corporate and commercial loans.

Banks apply this model to protect themselves from harmful loans. However, it is crucial to understand that most loans registered in bankbooks pose looming dangers. It is a major concern that most bank directors or managers are not able to identify this problem even when they use the re-pricing model. Therefore, this situation raises concerns regarding the effectiveness of this model in keeping bankbooks free from the risks associated with this model.

It is important for banks to think about the implications of this model before applying it. This should involve comparing its advantages with its limitations. The problem with this model, however, does not come from legal peril or

credit risk. The main issue is that it receives little attention from managers and director. This involves the market index applied in the re-pricing model for most loans provided by corporate and commercial lenders. Indeed, this is a looming danger that could cost banks vast amounts of their income.

The United States, for example, has banks with a common practice of employing US based index for re-pricing long-term loans for real estates. For instance, consider a bank that grants a loan to a local business organization with a re-pricing agreement of five years. The conditions for re-pricing included a five-year constant maturity treasury (CMT) index (Kosmidou and Zopounidis, 2004). After the loan is subjected to re-pricing, the bank will undertake the five-year period as stipulated by the CMT, in addition to the previous period. This is supposed to compensate because of high risk associated with commercial loans to calculate a new rate. Considering that the constant maturity treasury index has already been specified within the contract, it is not possible to replace it with a different condition because the other index is still in application.

Risk Books and Kamakura Corporation (2008) state that applying the re-pricing model raises concerns over what decision will be made after five years when the CMT index ceases being inefficient as a re-pricing standard. This is as secondary changes in the capital market affect how CMT relates with other indices. In other words, these concerns enquire about what would happen if the CMT index applies a new interest rate that is lower than the standard rate. This would thereby make banks charge their borrowers a lower rate. It would translate to a worse case scenario if the borrowers had

many loans. This crucial problem emanates from applying the re-pricing model that bank directors and managers are supposed to assess.

The major issue is that bank directors and CEO’s are not aware of this conundrum and its implications. When dealing with the challenge of this pricing index, banks should act to avoid applying the re-pricing model by providing balloon loans paid off in the loan period. This strategy would allow banks to make negotiations on the loan price and realign it with the correct terms and conditions. Regardless, there are competing issues that may compel banks to continue providing term loans to their best or loyal clients. According to Harrington and the Organisation for Economic Co-operation and Development (2007), most borrowers do not approve balloons mainly because they require renegotiation of the entire loan. If a bank provides a borrower with the term loan option, this would force competing banks to do the same. Similarly, it may be possible to lower the reset intervals. This provides the bank with a degree of protection in case the treasury index and market rates are disconnected overtime.

The fact that the re-pricing model does not consider income derived from activities beyond the balance sheet lowers its effectiveness. Big banks can use their internal models to re-price securities everyday. In this case, it is easy to estimate daily re-pricing of investment risks for a whole year. The flow of runoff cash blurs assets that were settled before the maturity period and withdraws liabilities abruptly. If any of the amounts is higher than the expected value, then the estimated rate of interest undertaken by the bank or financial institution becomes erroneous. Similarly, the model applies a

unified change interest change for diverse maturity periods. This model does not account for the value of interest rates for assets and liabilities. Additionally, if on average assets undergo re-pricing before liabilities and the rate of interest falls, then banks and financial institutions will be subjected to risks when they invest.

Ordinarily, financial institutions will not be able to predict their markets as they look to maintain a zero gap. Moreover, the model does not consider the effect of market value on liabilities and assets when attaining the preferred GAP level. Another deficient factor of this model comes through when it prioritizes on the sensitivity of the current interest rate on assets and liabilities. Thus, it ignores the effect of interest rate movements on the value of assets and liabilities. This model also does not succeed in incorporating the effect of changes in interest rates on the volume of assets and liabilities. The re-pricing model hence has been applied by many institutions by keeping them secure. Ultimately, the discussion above has managed to provide an informed explanation that it is not a suitable measure to offer complete protection to corporate and commercial loans.

Conclusion Conclusively, this report has managed to conduct a comprehensive study on the asset management liability or ALM. The study report involved giving a description of the mechanisms and processes that manages the various risks bank and financial institutions. These risks result from mismatches between liabilities and assets. In turn, this mismatch emanates from changes in interest rates or liquidity.

Liquidity implies a bank’s ability of satisfying its liabilities through borrowing or conversion of assets. Similarly, a bank may oversee a mismatch due to changes in interest rates. This is because banks have a tendency of acquiring loans on a short-term period and providing them on a long-term. In this regard, asset management liability helps in managing risks coming from differences between assets and liabilities. Banks and financial institutions are prioritizing this form of management increasingly because it has a direct effect on their survival and competitive edge. It is important to understand that a mismatch between liabilities and assets causes various risks such as capital risk, interest rate risk, credit risk, and liquidity risk. Additionally, this assessment has provided an analysis of the various models used in asset management liability in managing the mismatch of assets and liabilities.

These models include the gap analysis model, simulation model, time value at risk value, and the duration model. The re-pricing model in particular plays an important role at facilitating commercial and corporate lending of loans. Even though this model plays a significant role in safeguarding banks against risks associated with corporate and commercial loans, its effectiveness is plagued by a number of limitations. For instance, this model does not take into consideration the effects of market value on assets and liabilities. Additionally, the re-pricing model assumes that banks are capable of adjusting flexibly their assets and liabilities when pursuing a preferred GAP level. Similarly, if focuses on the sensitivity of interest rate and its relation to assets and liabilities.

Even though re-pricing is mooted as an efficient model for managing the mismatch of assets and liabilities, its limitations compromise its effectiveness. Reference Bessis, J. (2002). Risk management in banking. New York: Wiley.

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