IMPORTANCE AND ROLE OF ALCO

Asset & Liability Management

Bank Asset and Liability Management is an art which is as old as banking itself. Banks and other financial institutions are in the risk taking business. They use their risk expertise in risk valuation, which involves very sophisticated instruments, to generate optimum level of returns. The types of risk exposure taken on can be subtle & complex, not only the individual product themselves, but also interacting with external market factors. While accessing the risk exposure, it is important considering the Balance sheet as a whole.

Bank asset and liability management can be defined as:

“The practice of matching the term structure and cash flows of an organisation’s asset and liability portfolios to maximise returns and minimise risk”

The main objective of Asset and Liability management is to manage the interest rate risk and its correlated risks, with the objective of maximising growth or sustainability.

Banks normally have a committee which normally comprise of senior management of a bank, including the head of divisions and other specialists, which makes important decisions of a bank related to its balance sheet. This committee is called as Asset & Liability Committee (ALCO). It is a risk management committee. It normally meets once a month at least to analyse, review and formulate strategy to manage balance sheet.
The ALM management structure is as follows

Assets and liabilities of a bank are monitored through ALCO. The following chart shows the flow of information in a bank's Asset and Liability committee.

In every ALCO meeting, the key points of discussion are noted and action points are highlighted for improving the balance sheet of the bank. In the next ALCO meeting, the action points are reviewed to ensure implementation.
Key roles and functions of ALCO vary for every bank. It is sometimes responsible for general management policy. Its main functions are:

- Review reports on different risks including credit risk, interest rate risk and capital management covered in the report;
- Identify balance sheet management issues like balance sheet gaps, interest rate gap, that lead to under performance;
- Review the ratios of interest-rate-sensitive assets to liabilities;
- Review maturity distribution of liquidity book;
- Review current liquidity position and expected liquidity position in short and medium term;
- Current interest rates on loans and deposits to make sure that these are in accordance with overall lending and funding strategy (deposit pricing strategy);
- To define transfer pricing policy of a bank; and
- “What if”, test scenarios to check for the changes in market conditions and its effects on banking book and setting of risk tolerance.

Balance sheet risk management:

ALCO plays an important role in the management of Balance sheet risk management.

- It reviews the actions taken in previous meeting;
- Liquidity risks related to balance sheet;
- Economic conditions & market outlook;
- Review the cost & interest rate structure; &
- Actions to be taken.

Capital Structure:

ALCO committee keeps a closer look at company’s capital structure and makes sure that all the regulatory requirements are complied with. It makes sure that company is well capitalised and meets the requirements of BASEL I & II and maintains total risk based capital ratio, tier1 risk based capital ratio and tier1 leverage ratio.
**GAP:**

GAP is the difference between rate sensitive assets RSA and rate sensitive Liabilities RSL. ALCO measures the bank gap and interest rate exposure. Gap reports are used to measure the risks to net interest arising from re-pricing of assets and liabilities.

When RSA – RSL >0, the bank is said to have a positive GAP;

When RSA – RSL<0, the bank is said to have negative GAP; &

Where RSA- RSL = 0, the bank is said to have no GAP.

**Liquidity & Funding:**

Another important function of ALCO is to make sure that the bank has sufficient liquid resources to meet the demands of its customers. It also keeps an eye on diversification, cost robustness of funding sources and current and new funding structure.