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Balance Sheet Management in Banks

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Raising of Capital

A bank's core strength comes from its common equity capital. The level of its common equity capital determines the bank's stability. Capital planning, thus, is extremely important for a bank, as its ability to do business and take risks depends on its capital adequacy. A capital plan helps a bank forecast if its retained earnings would be enough to finance its projected growth in the coming years, or if it needs to raise capital. Planning for its capital needs in advance allows a bank flexibility in terms of timing the raising of capital. It can thus, factor in market conditions and unforeseen events. The following points can be kept in mind while capital planning:

- The understanding of the importance of efficient use of capital should not be restricted to higher management. Even an employee at the branch level and at every other operational level should understand this issue.
- Timing is a very important factor that needs to be considered while raising capital. It is easier to raise capital when the market is not flooded with similar issues. Market conditions and unexpected events can play an important part in deciding the success of an issue of capital.

Asset- Liability Management

Asset Liability Management (ALM) is the process undertaken by a bank that ensures that resources are raised and deployed in a manner that keeps various risks at an optimal level, while maximising the profits. This process entails identifying various risks, quantifying them, ensuring that they are adequately priced so that profit is maximised given the determined risk level, and subsequently attempting to ensure that the disruptions from these risks are minimised.

Tracking the continuous changes in the way the banking business is conducted and the ever-changing external environment is an important constituent of the ALM function. These factors affect risk at a strategic level, and hence need to be continuously monitored. While these days a lot of information is available that enables such tracking, the frequency and intensity of unforeseen events and their effects has also heightened. It needs to be ensured that such unforeseen events do not affect the bank too adversely.

Ensuring efficient use of capital is the other important function of ALM. Growth of loans and advances need not necessarily lead to a proportionate growth in Risk-Weighted Assets (RWA). Some ways of limiting the growth in RWA without affecting loan growth are:

- Giving more performance guarantees rather than financial guarantees.
- Getting borrowers rated so that the risk weight and hence required capital comes down.
- Covering the export credit portfolio through ECGC (Export Credit Guarantee Corporation).

- Covering medium and small sector loans through CGT-MSE (Credit Guarantee fund Trust for Micro and Small Enterprises).

Transfer pricing can be used as an instrument for transmitting organisational strategy and policy to various departments and branches of the bank. It can also be used to make these individual units aware of the costs associated with their activities, and thereby more aware of their profitability. This helps keep the unit goals in line with organisational goals.

Management of the various risks faced by a bank requires availability, accuracy, adequacy and timeliness of information. It also requires top management involvement, and their commitment to ALM.

Liquidity risk is the biggest risk that a bank could face in the short-term. Even a temporary liquidity problem could spiral out of control, despite the bank being solvent. This would necessitate decisions that sacrifice profitability in order to ensure survival. Bad credit decisions on the part of banks have been known to lead to liquidity problems not just for the banks, but for entire financial markets. Hence, growth decisions should always be in sync with well-informed and well-thought out ALM decisions. Liquidity risk can hit a bank from either side, i.e. the risk might not necessarily be of shortage of liquidity, but even of excess liquidity. The bank may suddenly be flush with funds without having adequate profitable avenues to deploy them. Intra-day liquidity, too, is an important factor that needs to be managed on a continuous basis.

A few factors that can result in excessive liquidity risk are:

- Too much dependence on short-term deposits. In a confusing economic scenario (e.g. high inflation coupled with low growth), banks may not like to take a long term view on interest rates. In case of an interest rate hike in such a scenario, banks may increase short term rates while leaving the long term rates untouched. This generally leads to a massive increase in their short term deposits.
- Excessive dependence on bulk deposits. Though these deposits may be easier to raise, they are also faster to vanish in adverse circumstances.
- Excessive interconnectedness within the financial system can result in system-wide problems. The RBI addresses this issue through its guidelines which have inbuilt ceilings on lending to and borrowing from other players in the system.

However, maturity transformation is an important role played by the banking sector and cannot be eliminated. It reduces the cost of capital for the economy as a whole, and as long as the shadow banking sector is not involved, the banks are adequately regulated, the liquidity risks are contained, and good liquidity standards are in place, is a an essential function that banks would need to continue to undertake.

The CFO of a bank needs to evaluate the market risk faced by the bank on the basis of its effect on the balance sheet as a whole, rather than just on the basis of its effect on the trading book. Market risk affects banks in two ways- firstly, by affecting its earnings through its Net Interest Income, and secondly, by affecting the networth through the market value of its risk sensitive assets and liabilities. A bank's exposure to interest rate risk, which is a major part of its market risk, can be evaluated through:

- Duration of assets and liabilities
- Modified duration of assets and liabilities
- Gap analysis: An analysis of the gap between a bank's Risk Sensitive Assets (RSA) and Risk Sensitive Liabilities (RSL).
- Modified Duration Gap

Banks should actively manage their interest rate risk by taking a view on interest rates and determining the acceptable level of asset liability mismatch.

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