Asset Liability Management

Non-Banking Financial Companies (NBFC) are exposed to credit and market risks in view of the asset-liability transformation. With liberalisation in Indian financial markets over the last few years and growing integration of domestic markets with external markets and entry of multinational companies for meeting the credit needs of not only the corporate but also the retail segments, the risks associated with NBFCs' operations have become complex and large, requiring strategic management.

NBFCs are now operating in a fairly deregulated environment and are required to determine on their own, interest rates on deposits, subject to the ceiling of maximum rate of interest on deposits they can offer on deposits prescribed by the Bank; and advances on a dynamic basis. The interest rates on investments of NBFCs in government and other securities are also market related. Intense competition for business involving both the assets and liabilities has brought pressure on the management of NBFCs to maintain a good balance among spreads, profitability and long term viability. Imprudent liquidity management can put NBFCs' earnings and reputation at great risk and these pressures call for structured and comprehensive measures.

The managements of NBFCs have to base their business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy. NBFCs are exposed to three major risks in the course of their business - credit risk, market risk and operational risk. It is, therefore, important that NBFCs introduce effective risk management systems that address the issues relating to market risks primarily interest rate and liquidity risks.

NBFCs need to address these risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices. ALM provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate risks of the NBFCs that needs to be closely integrated with the business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.

The ALM process rests on three pillars:

1. **ALM Management - Information Systems, its availability, accuracy, adequacy and expediency**

   ALM should be supported by a management philosophy which clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary information system as back up. The central element for the entire ALM exercise is the availability of adequate and accurate information with expedience. Collecting accurate data in a timely and speedy manner is the major requirement. This needs computerization and the data should be networked.

2. ALM Organisation –Its structure, responsibilities and top level involvement

The risk management process would require strong commitment on the part of the senior management in the NBFC, to integrate basic operations and strategic decision making with risk management. The Board should have overall responsibility for management of risks and should decide the risk management policy of the NBFC and set limits for liquidity and interest rate risks. There should be an executive level Committee styled as Asset Liability Committee (ALCO) at the top. For a Deposit Taking NBFC (NBFC-D) with asset size of Rs. 100 crores and above or holding public deposits of Rs. 20 crores and above, there is also a need to additionally constitute a Board level Risk Management Committee as per Corporate Governance Guidelines issued by RBI.

The ALCO consisting of the NBFC's senior management including Chief Executive Officer (CEO) should be responsible for ensuring adherence to the limits set by the Board as well as for deciding the business strategy of the NBFC (on the assets and liabilities sides) in line with the NBFC's budget and decided risk management objectives. The committee will be chaired by CEO/CMD/President or the Director and the Chiefs of Investment, Credit, Resources Management or Planning, Funds Management / Treasury, International Business and Economic Research can be members of the Committee. In addition, the Head of the Technology Division should also be an invitee for building up of MIS and related computerisation.

The ALM Support Groups consisting of operating staff should be responsible for analysing, monitoring and reporting the risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to NBFC's internal limits.

The responsibilities of ALCO, which is a decision making unit, is balance sheet planning from risk return perspective including the strategic management of interest rate and liquidity risks. Each NBFC will have to decide on the role of its ALCO, its responsibility as also the decisions to be taken by it. The business and risk management strategy of the NBFC should ensure that the NBFC operates within the limits / parameters set by the Board. The business issues that an ALCO would consider, inter alia, will include product pricing for both deposits and advances, desired maturity profile and mix of the incremental assets and liabilities, prevailing interest rates offered by other peer NBFCs for the similar services/product, etc. In addition to monitoring the risk levels of the NBFC, the ALCO should review the results of and progress in implementation of the decisions made in the previous meetings. The ALCO would also articulate the current interest rate view of the NBFC and base its decisions for future business strategy on this view. In respect of the funding policy, for instance, its responsibility would be to decide on source and mix of liabilities or sale of assets.

Towards this end, it will have to develop a view on future direction of interest rate movements and decide on funding mixes between fixed ***vs*** floating rate funds, wholesale ***vs*** retail deposits, money market ***vs*** capital market funding, domestic ***vs*** foreign currency funding, etc. Individual NBFCs will have to decide the frequency of holding their ALCO meetings.

3. ALM Process - Parameters, identification, measurement, Risk management, policies and tolerance levels

The ALM process involves management of market risks - liquidity risk management, interest rate risk management, funding and capital planning, profit planning and growth projection, forecasting, analysing 'What if scenario' and preparation of contingency plans.

Liquidity Risk Management

Measuring and managing liquidity needs are vital for effective operation of NBFCs. By ensuring an NBFC's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. NBFCs management should measure not only the liquidity positions of NBFCs on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid, like Government securities and other money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool.

The Maturity Profile should be used for measuring the future cash flows of NBFCs in different time buckets. The time buckets, may be distributed as 1 day to 30/31 days (One month), over one month and up to 2 months, over two months and up to 3 months, over 3 months and up to 6 months, over 6 months and up to 1 year, over 1 year and up to 3 years, over 3 years and up to 5 years and over 5 years.

NBFCs holding public deposits (NBFC-D) are required to invest up to a prescribed percentage (15% as on date) of their public deposits in approved securities in terms of liquid asset requirement of Section 45-IB of the RBI Act, 1934. Thus various NBFCs would be holding in their investment portfolio securities which could be broadly classifiable as 'mandatory securities' (under obligation of law) and other 'non-mandatory securities'.

In case of NBFCs not holding public deposits (NBFC-ND), all the investment securities and in case of NBFCs holding public deposits (NBFC-D), the surplus securities (held over and above the requirement) would fall in the category of 'non-mandatory securities'. The NBFCs holding public deposits (NBFC-D) is given the freedom to place the mandatory securities in any time buckets as suitable for them. The listed non-mandatory securities may be placed in any of the "1 day to 30/31 days (One month)", Over one month and upto 2 months" and "Over two months and Up to 3 months" buckets depending upon the defeasance period (time taken to liquidate the position on the basis of liquidity in the market) proposed by NBFCs. The unlisted non-mandatory securities (eg; equity shares, securities without a fixed term of maturity etc.) should be placed in the "Over 5 years" buckets, whereas unlisted non-mandatory securities having a fixed term of maturity may be placed in the relevant time bucket as per residual maturity. The mandatory securities and listed securities may be marked to market for the purpose of the ALM system. Unlisted securities should be valued as per Prudential Norms Directions.

Alternatively, the NBFCs can also follow the concept of Trading Book wherein the composition and volume are clearly defined, maximum maturity/duration of the portfolio is restricted, the holding period not to exceed 90 days, cut-loss limit prescribed and defeasance periods (product-wise) are prescribed.

NBFCs which maintain such ‘Trading Books’ and are complying with the above standards should show the trading securities under "1 day to 30/31 days (One month)", Over one month and up to 2 months" and "Over two months and up to 3 months" buckets on the basis of the defeasance periods. The Board/ALCO of the NBFCs should approve the volume, composition, holding/defeasance period, cut loss, etc. of the ‘Trading Book'. The remaining investments should also be classified as short term and long term investments as required under Prudential Norms.

Within each time bucket, there could be mismatches depending on cash inflows and outflows. While the mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus should be on the short-term mismatches viz., 1-30/31 days. NBFCs, however, are expected to monitor their cumulative mismatches across all time buckets by establishing internal prudential limits with the approval of the Board / Management Committee.

The mismatches (negative gap) during 1-30/31 days in normal course may not exceed 15% of the cash outflows in this time bucket.

The **Statement of Structural Liquidity** may be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability will be a cash outflow while a maturing asset will be a cash inflow.

While determining the likely cash inflows / outflows, NBFCs have to make a number of assumptions according to their asset - liability profiles. While determining the tolerance levels, the NBFCs may take into account all relevant factors based on their asset-liability base, nature of business, future strategy, etc.

The NBFCs monitor their short-term liquidity on a dynamic basis over a time horizon spanning from 1 day to 6 months by estimating their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.

Interest Rate Risk Management

Interest rate risk is the risk where changes in market interest rates might adversely affect an NBFC's financial condition. The immediate impact of changes in interest rates is on NBFC's earnings (i.e. reported profits) by changing its Net Interest Income (NII). A long-term impact of changing interest rates is on NBFC's Market Value of Equity (MVE) or Net Worth as the economic value of NBFC's assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. The interest rate risk when viewed from these two perspectives is known as 'earnings perspective' and 'economic value perspective', respectively. The risk from the earnings perspective can be measured as changes in the Net Interest Income (NII) or Net Interest Margin (NIM).

The traditional Gap analysis is considered as a suitable method to measure the Interest Rate Risk. After acquiring sufficient expertise and sophistication in handling MIS, NBFCs can move to modern techniques of Interest Rate Risk measurement like Duration Gap Analysis, Simulation and Value at Risk.

The Gap or Mismatch risk can be measured by calculating Gaps over different time intervals as at a given date. Gap analysis measures mismatches between rate sensitive liabilities and rate sensitive assets (including off-balance sheet positions). An asset or liability is normally classified as rate sensitive if:

- within the time interval under consideration, there is a cash flow;
- the interest rate resets/reprices contractually during the interval;
- dependent on RBI changes in the interest rates/Bank Rate;
- it is contractually pre-payable or withdrawal before the stated maturities.

The Gap Report should be generated by grouping rate sensitive liabilities, assets and off-balance sheet positions into time buckets according to residual maturity or next repricing period, whichever is earlier. All investments, advances, deposits, borrowings, purchased funds, etc. that mature/reprice within a specified timeframe are interest rate sensitive. Similarly, any principal repayment of loan is also rate sensitive if the NBFC expects to receive it within the time horizon. This includes final principal payment and interim instalments. Certain assets and

liabilities, having a linkage to reference rate, receive/pay rates. These assets and liabilities are repriced at pre-determined intervals and are rate sensitive at the time of repricing.

The Gaps may be identified and slotted into various time buckets. The time buckets, may be distributed as 1 day to 30/31 days (One month), over one month and up to 2 months, over two months and up to 3 months, over 3 months and up to 6 months, over 6 months and up to 1 year, over 1 year and up to 3 years, over 3 years and up to 5 years, over 5 years and non-sensitive.

The Gap is the difference between Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) for each time bucket. The positive Gap indicates that it has more RSAs than RSLs whereas the negative Gap indicates that it has more RSLs than RLAs. The Gap reports indicate whether the institution is in a position to benefit from rising interest rates by having a positive Gap (RSA > RSL) or whether it is in a position to benefit from declining interest rates by a negative Gap (RSL > RSA). The Gap can, therefore, be used as a measure of interest rate sensitivity.

Each NBFC should set prudential limits on individual Gaps with the approval of the Board/Management Committee. The prudential limits should have a relationship with the Total Assets, Earning Assets or Equity. The NBFCs may work out Earnings at Risk (EaR) or Net Interest Margin (NIM) based on their views on interest rate movements and fix a prudent level with the approval of the Board/Management Committee.

Filing of Returns:

The ALM guidelines introduced on 27 July 2001 was applicable only to Systemically Important Deposit taking NBFCs (NBFC-D) with asset size of Rs.100 crores and above or with public deposits of Rs. 20 crores and above. Such NBFC-Ds were required to make the ALM guidelines operational from 31 March 2002 and submit one consolidated half yearly ALM return to Reserve Bank of India (Comprising of three parts - (i) Statement of structural liquidity in format ALM (ii) Statement of short term dynamic liquidity in format ALM and (iii) Statement of Interest Rate Sensitivity). This reporting continues till date and there has been no amendment made to the applicability of ALM returns filing to NBFC-D despite all NBFC-Ds irrespective of their asset size having been declared as Systemically Important by Reserve Bank of India (RBI) vide Notification No. DNBR (PD) CC.No. 002/03.10.001/2014-15 dated 10 November 2014.

The ALM guidelines were made applicable to Systemically Important Non Deposit taking NBFC (NBFC-ND-SI) with asset size of Rs.100 crores and above vide Notification No. DNBS (PD). CC. No. 125/03.05.002 / 2008-2009 dated 1 August 2008. Three separate returns were introduced for submission to RBI from 1 January 2009 - (i) Monthly Statement of short term dynamic liquidity

[NBS-ALM1] (ii) Half yearly Statement of structural liquidity [NBS-ALM2] (iii) Half yearly Statement of Interest Rate Sensitivity [NBS-ALM3]. Also an annual disclosure was required in the Balance Sheet with respect to "ALM-Maturity pattern of certain items of Assets and Liabilities". This reporting continues till date despite the reclassification of NBFC-ND-SI as those with asset size of Rs.500 crores and above by RBI vide Notification No. DNBR (PD) CC.No. 002/03.10.001/2014-15 dated 10 November 2014 there was no change in ALM reporting**.** The definition of Systemic Importance for NBFC-NDs for the purpose of submission of all the above mentioned three ALM returns and annual ALM dislosure in the Balance sheet continues to be in force for NBFC-NDs with asset size of Rs. 100 crores and above only.