CMR Institute of Technology

Department of Management Studies

Answer key

III Internal test – II semester MBA (2017-19 Batch)

Subject: Principles & Practices of Banking Sub Code: 17MBAFM301 Date: 19.11.2018 Time: 9:00-10:30 Duration: 90 mins

Part A - Answer Any Two Full Questions (16*02=32 Marks)

1. a) Define ALM.

Asset Liability Management (**ALM**) can be defined as a mechanism to address the risk faced by a **bank** due to a mismatch between assets and liabilities either due to liquidity or changes in interest rates. Liquidity is an institution's ability to meet its liabilities either by borrowing or converting assets. Explain the factors effecting the Forex Rate.

b. Explain the objectives of asset liability management in banks.

Concept of Assets /Liabilities Management (ALM):

ALM refers to the management of a bank's portfolio of assets and liabilities in order to maximize profitability and stockholders' earnings over long term, consistent with safety and liquidity considerations. ALM addresses to the responsibility of managing the acquisition and allocation of funds to ensure adequate liquidity, maximum profitability and minimizing risks.

It includes reviewing recent/past performance of exposures as an indicator to take up future activities. It involves the assessment of the funding strategies, as consideration is required to be given to, both liquidity and return. Such exercise calls for monitoring the distribution of assets and liabilities in terms of volume, rates and mix. The review of budgets and earnings is generally the tool used for this purpose.

Objectives of Assets /Liabilities Management (ALM):

Based on the aforesaid premise, the broad objectives of ALM are:

1. Planning to Meet the Liquidity Needs:

Making funds available at a competitive price when they are required is the first task of ALM. The task is to achieve a proper mix of funds by keeping the level of non-interest funds to the bare minimum, maximize the fund allocation to high profit areas while simultaneously ensuring availability of funds to meet all eventualities.

2. Arranging Maturity Pattern of Assets and Liabilities:

Matching of assets and liabilities over different time bands and keeping a tag on their pricing by limiting their exposure to interest rate risk are issues to be looked at in the ALM process.

3. Controlling the rates received and paid to assets /liabilities to maximize the spread or net interest income is the final responsibility of ALM.

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The aforesaid objectives are accomplished without exposing the bank to excessive risk of default. Primarily employing a three pronged strategies described below ensures the attainment of these tasks,

4. Spread Management:

Spread or margin, known differently as interest spread or interest margin or net interest spread/margin or net interest income refers to the difference between interest earned on deployment and interest paid on the acquisition of financial resources.

Spread maximization strategy involves:

1. Reducing bank’s exposure to cyclical rates and stabilizing earnings over the long term,

2. Predicting rate changes and planning for such eventualities,

3. Coordinating rate structure,

4. Balancing default risk on loans and investments against probable benefits, and

5. Ensuring a steady but controlled growth as also gradual increase in profitability.

5. Gap Management:

Gap refers to the difference between assets and liabilities that can be impacted due to the change in the interest rates. Such assets/liabilities are referred to as rate sensitive assets (RSA) and rate sensitive liabilities (RSL) respectively.

c. Describe ALM Committee? Explain its functions.

The exact roles and perimeter around ALM can vary significantly from one bank (or other financial institutions) to another depending on the business model adopted and can encompass a broad area of risks.

The traditional ALM programs focus on interest rate risk and liquidity risk because they represent the most prominent risks affecting the organization balance-sheet (as they require coordination between assets and liabilities).

But ALM also now seeks to broaden assignments such as foreign exchange risk and capital management. According to the Balance sheet management benchmark survey conducted in 2009 by the audit and consulting company PricewaterhouseCoopers (PwC), 51% of the 43 leading financial institutions participants look at capital management in their ALM unit.

The scope of the ALM function to a larger extent covers the following processes:

1. Liquidity risk: the current and prospective risk arising when the bank is unable to meet its obligations as they come due without adversely affecting the bank's financial conditions. From an ALM perspective, the focus is on the funding liquidity risk of the bank, meaning its ability to meet its current and future cash-flow obligations and collateral needs, both expected and unexpected. This mission thus includes the bank liquidity's benchmark price in the market.

2. Interest rate risk: The risk of losses resulting from movements in interest rates and their impact on future cash-flows. Generally because a bank may have a disproportionate amount of fixed or variable rates instruments on either side of the balance-sheet. One of the primary causes are mismatches in terms of bank deposits and loans.
3. Capital markets risk: The risk from movements in equity and/or credit on the balance sheet. An insurer may wish to harvest either risk or fee premia. Risk is then mitigated by options, futures, derivative overlays which may incorporate tactical or strategic views.
4. Currency risk management: The risk of losses resulting from movements in exchanges rates. To the extent that cash-flow assets and liabilities are denominated in different currencies.
5. Funding and capital management: As all the mechanism to ensure the maintenance of adequate capital on a continuous basis. It is a dynamic and ongoing process considering both short- and longer-term capital needs and is coordinated with a bank's overall strategy and planning cycles (usually a prospective time-horizon of 2 years).
6. Profit planning and growth.
7. In addition, ALM deals with aspects related to credit risk as this function is also to manage the impact of the entire credit portfolio (including cash, investments, and loans) on the balance sheet. The credit risk, specifically in the loan portfolio, is handled by a separate risk management function and represents one of the main data contributors to the ALM team.

The ALM function scope covers both a prudential component (management of all possible risks and rules and regulation) and an optimization role (management of funding costs, generating results on balance sheet position), within the limits of compliance (implementation and monitoring with internal rules and regulatory set of rules). ALM intervenes in these issues of current business activities but is also consulted to organic development and external acquisition to analyse and validate the funding terms options, conditions of the projects and any risks (i.e., funding issues in local currencies).

2 (a) Define Discounting of bills?

An accepted draft or **bill** of exchange sold for early payment to a bank or credit institution at less than face value after the bank deducts fees and applicable interest charges. The bank or credit institution then collects full value on the draft or **bill** of exchange when payment comes due.

(b) Examine Bank overdraft and the advantages of bank overdraft to corporate.

A bank overdraft is a facility extended by a bank to corporates and other clients to withdraw funds from their account in excess of the balance. This facility is provided by the bank for a fee and/or interest is charged on the excess amount that is withdrawn for the length of the time. It is important to know the advantages and disadvantages of the bank overdraft facility in order to use it effectively.

An overdraft facility allows the facility holder to withdraw money from the account despite having no balance. There is a limit on the amount that can be overdrawn from the account. The overdraft limit is usually set by the bank basis the amount of working capital, creditworthiness of borrower and security offered by borrower.

Advantages of Bank Overdraft

Handles Timing Mismatch of Flow of Funds

A bank overdraft is usually the best for businesses with greater movement of cash flow in a given time frame. An overdraft can help reset a skipped cycle of rotation of inflow and outflow of cash. In other words, if sales proceeds and purchases result in a flow of money in and out many times during a week/month; an overdraft facility allows managing cash flow gaps that might arise due to timing mismatch.

Helps in Keeping Good Track Record

If a check was made on the basis of some amount to be received, and if it is delayed, the check does not bounce due to inadequacy of funds. Hence, overdraft facility allows for a better payment history.

Timely Payments

It also ensures timely payments and avoidance of late payments penalties as payments can be made even if there is a lack of sufficient balance in the account.

Less Paperwork

It requires less paperwork that would usually be required in long-term loans as overdraft facility is easy to avail.

Flexibility

Overdraft facility has the advantage of flexibility as one may take it at any time, for any amount (up to the limit allotted), and for even as less as one or two days.

Benefit of Less Interest Cost

The interest is calculated only on the amount of funds used. This allows for greater savings in the interest cost compared to a normal loan taken for a fixed time period. While in other loans, interest is required to be paid even if the money remains unused. In this case, the charging of interest starts with the amount over drawn and it stops instantly when it is paid off.

Disadvantages of Bank Overdraft

Higher Interest Rates

Overdraft facility comes at a cost. At times, the cost is usually higher than the other sources of borrowing.

Risk of Reduction in Limit

Overdraft facility is a temporary loan and undergoes regular revisit by the bank. Hence, it runs a risk of a decrease in the limit or withdrawal of the limit. Reduction in the withdrawal of limit may happen usually when company financials may represent poor performance; hence, the facility may be withdrawn especially when the company may require it the most.

Risk of Seizing

Bank overdraft facility may at times be secured against inventory or other collaterals like shares, life insurance policies etc. The company may run a risk of those assets being seized if it fails to meet payments.

Debtor’s Collection becomes Lethargic

At times, availability of overdraft facility may make the company less strict on the collection of debtors' payment. In other words, a company may not be too much on their feet to collect payments from debtors, as immediate payment outflows can be managed by overdraft facility.

3.a Define Pledge

A thing that is given as security for the fulfilment of a contract or the payment of a debt and is liable to forfeiture in the event of failure.

3.(b) Explain different ways of creating charges on the security.

Types of Charges:

Type of Charge	**Is created on**	**Such as**	**And the possession of the asset is with**
I. Mortgage	Immovable Properties (properties that do not move!)	Land and Building	Borrower…i.e., the one who has taken the loan.
II. Pledge	Movable goods or property	Share Certificates/NSC Certificates/Gold jewelley	Lender, i.e., the Bank = Pledgee
III. Hypothecation	Movable	Plant and Machinery/ Automobiles	Borrower.

	goods or property		Usually for car/vehicle loans…has anyone noticed that some autos have ‘Hypothecate to/with XYZ Bank, abc Branch..as on xx/xx/xxxx’ painted in small letters on the back.
IV. Lien	Paper security	Shares/Debentures/Mutual Funds/ Bonds	
V. Personal Liability	Is nothing but personal guarantee	By 3rd parties	Like a guarantee

3.c What is Lending? Explain the principles of Bank lending.

A banker follow certain basic **principles of lending** while doing carrying out their lending and credit operations. Banks deals with public money accepting deposit and lend to their borrowers to earn profit. Banks follow some fundamental principles of lending in order to ensure safety, security and profitability on money it lend. Lending is one of the most important functions performed by the commercial banks and is major source of income of bank.

Borrower may differ in terms of their purpose of advance, activities, financial health, repayment capacity, risk so some important principles / considerations are followed by bank before taking lending decision.

Important Principles of Lending in Banking | Credit Principles

These basic principles of bank lending affect bank's loan policies, credit operations to a great extent. Here are some important principles of lending :

- Safety
- Liquidity
- Purpose
- Diversity or Risk Spread
- Profitability
- Security

Safety

Safety is the most important fundamental principle of lending. Banks deal with public money so safety of money from public is first priority of bank. When a banker lends, he must be sure about that the money is in safe hand and will definitely come back at regular interval as per repayment schedule without any default. Safety of funds depends on nature of security, character of borrower, repayment capabilities and financial health of the borrower.

Also Read : What is the difference between Cash Credit and Overdraft ?

A banker must ensure that finance extended by him goes to right type of borrower and is being used for the intended purpose. And also after utilizing it for right purpose it should be repaid with interest.

Liquidity

Liquidity is also an important principle of lending in banking. Bank lend public money which is repayable on demand by depositors so bank lends for a short period. A banker must ensure that money will come back on demand or as per repayment schedule. The borrower must be able to repay the loan within a reasonable time after demand for repayment is made.

‘Liquidity’ has as much importance as ‘safety’ of funds. The reason behind it is that a bulk of their deposit is repayable on demand or at a very short notice. Banker must ensure that money is locked up for a long time. If loan becomes illiquid, it may not be possible for bankers to meet their obligations vis a vis depositors.

Purpose

The underlying purpose for which an applicant is seeking a loan should be productive. The purpose of loan helps in determining level of risk and also impact interest rate on loan.

Purpose of loan should be productive in order to ensure safety of funds while it should be extended for short term to ensure liquidity.

Diversity / Risk Spread

Do not put all eggs in one basket – Bank follow this approach (principle of diversity) while creating its advances portfolio. Risk is always present while extending any kind of advance to any type of borrower. To minimize the risk, bank should lend to borrowers from different trades, industries like agriculture, education, IT, pharma, educational etc. Lending surplus to a particular sector may have adverse affect on bank in time of slump.

A banker must follow principle of diversity also while choosing its investment portfolio. He must invest the funds over different share and debentures of different industries rather than investing in particular type of security.

Profitability

Banks accept deposits from public and lend it to make profit. Banks also incur expenses to maintain deposits such as rent, stationary, premises rent, provision for depreciation of their fixed assets, bad loans. After incurring such expenditures, a bank must earn some profit like other financial institutions.

So a banker must extend the advance in such a way that it is profitable for bank and also at competitive lending rate.

Security

A banker avoid lending to a borrower without any security. Security act as an insurance to lender bank in case of default by the borrower. The banker carefully scrutinizes all the different aspects of an advance before granting it. At the same time, he provides for an unexpected change in circumstances which may affect the safety and liquidity of the advance. It is only to provide against such contingencies that he takes security so that he may realize it and reimburse himself if the well-calculated and almost certain source of repayment unexpectedly fails.