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Prudent Asset-liability Management in the time of Covid-19

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> Without being able to maintain proper spread and enough diversity in their portfolio, banks face the risk of extra provisioning which in turn will affect the capital adversely.

ABSTRACT

This article focuses on the importance of prudent Asset-Liability Management (ALM) that has come to the forefront following the onset of the Covid-19 pandemic. It outlines the meaning, significance, and the implication of Asset-Liability Management in the current scenario. The article highlights the various setbacks that economies throughout the world presently face, the steps taken by the different governments to address the crises and the effectiveness of the same with special emphasis on the methods adopted by the Bangladesh Bank. Finally, the article discusses the two kinds of assets- income generating and non-income generating, and the risks associated with them.

KEYWORDS: Asset-Liability Management, Covid-19, Market Risk, Financial Stability.

2020 has been a happening year to say the least. The pandemic, Covid-19, has hit every aspect of the economy throughout the world quite badly. The central banks as well as the governments of all countries are coming ahead with different plans to support the economy. Without these plans and stimulus packages, it will be very difficult for the world economy to revive. First world countries like USA, UK, Japan, Germany and Italy have all come forward with very large sums of stimulus packages. USA is currently topping the chart with $2.3 trillion, followed by Japan with $1.09 trillion, Italy with $823 billion, UK with $496 billion, and Germany with $384 billion. The

Bangladeshi Government has already announced 19 different stimulus packages worth $11.6 billion which is about 3.5 percent of the country's GDP since the first reported positive case of Covid-19 on 8th March, 2020. Being in the thick of the matters, banks have not been spared from the mayhem of this pandemic. On top of that, most of the funding of these stimulus packages are being done through banks. To ensure that both the borrower and the banks survive, banks will have to manage their asset-liability prudently.

Asset-Liability Management (ALM) is the process of planning, organizing and controlling asset and liability volumes, maturities, rates, and yields in order to minimize interest rate risk and maintain an acceptable profitability level as well as strengthen the core of the bank. Simply stated, ALM is another form of planning. It allows banks to be proactive and anticipate change, rather than react to unanticipated change. Realizing the importance of ALM, the central banks of all the countries have instructed to form an Asset-Liability Committee (ALCO) presided over by the senior management of the bank to oversee the matters. As we all know, banks collect deposits from the customers at a lower rate and lend the money to other customers at a higher rate. The difference between these two rates is called the 'Interest Rate Spread'. Now, to maintain profitability, the banks must keep this spread up to a certain level. Along with this, diversification of loan portfolio is a must. This has always been emphasized by all the regulatory authorities throughout the world. The reason behind this is that during any kind of economic slowdown, those banks or financial institutions having a diversified portfolio have always fared better than the others. Without being able to maintain proper spread and enough diversity in their portfolio, banks face the risk of extra provisioning which in turn will affect the capital adversely. Apart from these, there are other aspects like duration as well. Duration is an aspect that needs to be taken into account as banks have to run day to day activities and pay off its depositors whenever necessary.

Banks have various kinds of assets which can broadly be classified into two categories. One is income generating assets and the other is fixed or non-income generating assets. Amidst the pandemic, it's the income generating assets that should be the concern of banks. The reason for this is that they are the ones that are most closely linked with liquidity. The banks borrow money and then lend. The banks cannot lend all the money as they have some regulatory requirements to be fulfilled. Banks have to maintain an ADR (Advance Deposit Ratio). In Bangladesh, the banks have to generally maintain an ADR of 85 percent. But due to this pandemic situation and with a view to inject liquidity into the economy, Bangladesh Bank has allowed the ADR (Advance Deposit Ratio) to be as high as 87 per cent. A higher ADR will allow the banks to lend more to its customers as well as help the government fulfill its targets. However, this exposes the banks to more risk. Also, while the higher ADR will inject money supply into the economy, it may create a liquidity crisis for the banks. Due to the current situation, the customers may not be able to pay back the loan and hence, it will impose liquidity pressure on the banks as well as inflict loss. Thankfully, many governments have thought about the loss aspect and that is the reason why deferral periods have been announced. In that way, the banks have been spared of some losses for the time being. Bangladesh Bank has announced a loan deferral period for the whole of 2020. This will have both long term and short term effects. In the short term, it will bring some good results for the banks in terms of profit. However, on the other hand, banks will likely face liquidity crisis for both short term and long term. Because of this liquidity risk, banks may become unable to pay off its depositors which in turn can lead to a serious reputation loss for the banks.

ALM guidelines around the world have broadly mentioned two specific risks that are likely to impact a financial institution. They are – market risk and liquidity risk. As the liquidity risk has been addressed earlier, let's look at the market risk. Market risk is the risk of potential losses in the on-balance sheet and off-balance sheet positions of a bank. It stems from adverse movements in market rates or prices such as interest rates, foreign exchange rates, equity prices, credit spreads and/or commodity prices. During this period, the banks need to reevaluate some key points related to ALM as well as the risks mentioned. These points are–

1. **Managing the market risk:** Market risk is the

combination of all the risk factors of the market. The fluctuation in exchange rates need to be monitored. As the demand for luxury items is likely to be slowed down, the prices of these products will fall. So, financing in these sectors should be monitored closely. Hence, diversification of the loan portfolio in managing the asset-liability is of more importance than ever before.

2. **Balance sheet cash flows:** Balance sheets will continue to grow during the pandemic, but the cash flow is likely to change. Banks must consider the impact of loan amortizations and maturities, prepayments, curtailments, deferrals, as well as the changing frequency of loan originations. Also, they must consider the impact of the reduced fee income from loan originations or sales.

3. **Interest rate regime:** Interest rates all over the world are likely to face a shock. The current situation will not allow the banks to raise interest rate on loans. On the other hand, customers, knowing the risks, may want to invest in government securities as they are perceived to be a safer option. As a result, because of this risk premium, the customer will want more return. This is going to be a definite challenge. In Bangladesh, the Central Bank has set the upper limit for loans at 9 per cent. As the return on government securities is more than this, the banks will have to come out with strategies to maintain a favourable spread.

All the matters addressed above will determine how the overall economy fares. Banks are at the centre of any economy and the health of the banks is of foremost importance. In the upcoming months, Asset-Liability Management (ALM) will be one of the key factors in determining how each bank maintains their profitability and whether they barely survive or are able to thrive under the current situation.