
UNIT 2 FINANCIAL MANAGEMENT IN BANKS: AN INTRODUCTION

Objectives

The main objectives of the unit are to:

- explain the objective and scope of financial management in Banking Industry
- discuss the issues relating to management of different components of assets and liabilities
- provide an overview of asset-liability management
- highlight the importance of managing liquidity and risk in Banking Industry.

Structure

- 2.1 Introduction
- 2.2 Objectives of Financial Management
- 2.3 Scope of Financial Management
- 2.4 Managing Bank Liabilities
- 2.5 Managing Bank Assets
- 2.6 Asset-Liability Management
- 2.7 Managing Liquidity and Risk
- 2.8 Summary
- 2.9 Self-Assessment Questions
- 2.10 Further Readings

2.1 INTRODUCTION

Banks are essentially intermediary institutions, which collect savings and then convert them into productive capital. They create or expand credit in the economy and thus accelerate economic growth. Though substantial part of bank credit is in the form of short-term credit to industries or businesses, the concept is changing rapidly. Today, Banks are lending for long-term purposes and also expanding their activities to non-business entities. Banks are major lenders for consumer financing and housing finance. Like any other organisation, banks also handle large cash flows. In fact, the commodity they buy and sell is cash flows. Though there may not be any separate finance department in a banking company but managing cash flow and its components is critical for the success of any banking company. Financial management becomes integral part of banking operations. Issues like liquidity management and risk management are equally important for banks as in the case of any commercial organisation. Normally, the Treasury Department of the bank manages the flow of funds and also manages liquidity and risks associated with various activities of the bank. In that context, Treasury is centre of any banking company. In this unit, we will discuss the activities performed by Treasury Department of a Bank and through that we can understand how banks manage their finances.

2.2 OBJECTIVES OF FINANCIAL MANAGEMENT

Corporate financial managers always try to maximise the wealth of the shareholders by taking decisions, which increase the value of the company. This involves *raising money at lower cost, deploying the funds on activities*, which produce higher return

and finally *manage the risk*. These three activities put together maximise value of the firm. The same thing applies to a bank also and banks should also manage their finances in such a way that it maximises the wealth of owners of the bank. However, the degree of importance on the activities differs in banking industry from other commercial enterprises. The fund raising is a critical activity of the bank and hence like any other financial managers, the bankers should also aim to reduce the cost of borrowings. Deployment of funds is not a regular activity in a typical commercial organisation whereas for banks it will be a major activity. Here again, banks need to identify sources from where they can get maximum revenue. When it comes to risk management, again it will be a major activity. Every action on asset side or liability side of balance sheet of the bank has tremendous impact on the risk. Managing risk is yet another critical activity for the bank. Thus, the overall objective of the financial management in the banking context is maximising the wealth, which is achieved by

- (a) Reducing the cost of capital - deposits, borrowings and equity
- (b) Increasing lending rates
- (c) Minimising various kinds of risk like credit risk, duration risk, etc.
- (d) Above all, reducing the cost of operations

Activity-1

1) Suppose a bank has given a loan to a borrower some 3 years back when the borrower's credit rating was good. Though the borrower is regular in payment of interest and instalment, some changes in economic conditions pulled down the credit rating of the borrower. Do you think that this change in credit rating will have an impact on the wealth of the bank?

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2) Banks are now expanding their activities to several non-fund based activities. Are they risk-free? Discuss with some of your banking friends and identify few activities of this nature and map the risk and return profile of those activities.

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2.3 SCOPE OF FINANCIAL MANAGEMENT

As discussed earlier, the Treasury Department performs the financial management function in a bank. Treasury activities among other things include:

(a) Developing a plan for raising capital from various sources: Since substantial part of the resources comes through deposits of various kinds from the branch network, the Treasury has to develop suitable policies. More than developing policies, it requires periodical reviews to achieve a desired deposit mix. For instance, if the bank plans Rs. X cr. through 6 months deposits and Rs. Y cr. through 3 years deposits, there is no assurance that after a month, the branches raises the deposit in the same proportion. The Treasury is expected to monitor the deposit activities of the branches and then change the policies to give appropriate thrust for different types of deposits to achieve the planned deposit mix.

(b) Developing a plan for deploying resources in different assets: While banks need to hold some cash for meeting liquidity position, the profitability of the

operations directly depends on the lending-borrowing rates spread they earn. There are several options for investment and it ranges from traditional working capital lending to investing in markets. The time, return and risk for each type of lending/investments differ considerably. It is important to develop a long-term plan for asset portfolio mix. Though top management takes such decisions, it is the Treasury which operationalize the same by preparing the plan and communicating the same to divisions/branches. Not only planning is important, it is important to review the asset creation process and redirect the divisions and branches effort if the target is missed.

(c) **Managing Risk:** Most operations of bank create risk and it continues till such time the assets or liabilities are in the books. It is an important function of the treasury to quantify overall risk since some of the risks might get offset if the bank has equal position on the other side. Suppose a customer wants 7-year loan and if the loan is funded by 7-year deposit, then there is no additional risk on time element. However, the period may be same but one may be floating and the other one may be fixed. Though there is no risk on account of duration mismatch, the interest rate structure creates a fresh risk. Similarly, if the bank sold US Dollar forward cover, then they carry the exchange rate risk. Needless to say, banks take risk from corporate sector through several such schemes by charging a price. While hopefully some of the risks get cancelled with each other, they need to constantly measure the residual risks and take action to contain their impact on the bank.

The bank treasury constantly interacts with the branches and with the market to discharge the above functions. Many treasury divisions function round the clock particularly when their operations spread around the world.

Activity-2

- 1) Suppose you see a large-scale withdrawal of the deposits from your bank. As an employee of Treasury Division of the bank, what activities you think will be appropriate in handling the situation? Identify short-term and long-term plan to cope up with such situation.

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- 2) Suppose your bank wants to introduce a few new deposit schemes and loan schemes. What is the role of Treasury? To appreciate this issue, think of a manufacturing company in which the production and marketing departments decided to launch a new product through a new dealers’ network based on the customer’s feedback. What is the role of finance department? Relate these two while answering your question.

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2.4 MANAGING BANK LIABILITIES

As in the case of any business set up, banks also raise part of their Capital in the form of Equity and the balance through Borrowings. However, the level of borrowing will be substantially large in the case of banking industry for obvious reason. Table-2.1 shows the aggregate value of liabilities of over 100 banks in India, which includes private sector banks and foreign banks. Banks borrow between 16 to 20 times of their shareholders funds in the form of deposits and other borrowings. Banks trade in

capital. Managing liabilities become important in this context. When we look into the liabilities of a bank, there are several types. We can broadly classify them into long-term and short-term and several sub-classes are possible under each of these types.

Long-term Liabilities

By definition, any liability not required to be repaid within one year period is called long term liability. Long-term liabilities can be raised by issuing bonds or debentures or by accepting deposits. For instance, ICICI Bank comes out regularly with a large number of bonds issue, both for tax and non-tax purposes. ICICI Bank also accepts deposits from the public. What is the difference between these two types of borrowings? We are not concerned about the legal difference at this stage but our focus is more on financial issues of these two types of liabilities. Bond or debenture issues are for certain specific reasons and, normally, the minimum of investment will be slightly higher. Normally, there would not be any option to the holder for early redemption unless such bonds are for fairly long-term (25 years or so). They qualify for different types of risk capital since there will be no major pressure for early redemption. In view of active trading in the secondary market, these bonds can be sold whenever the holder needs capital. Normally, such bond issues are open for certain period of time. On the other hand, banks accept deposit for a small value and also at any time. Often, the deposit holder gets a right to close the deposit early and deposit it back again if the interest rates move up. Term deposits and other long-term borrowings constitute nearly 60% of the total borrowings.

Table 2.1: Liabilities of Banking Industry as at end of March

(Rs. in Crore)

	1998	1999	2000	2001	2002
Paid-up equity capital	19323.02	18015.96	18384.95	19234.58	20038.94
Reserves & surplus	24894.73	29323.19	36696.45	43707.63	56676.88
Deposits	642426.98	769093.05	901760.81	1059733.65	1211429.77
Demand deposits	94930.65	108616.64	129156.52	140313.85	153866.04
Saving deposits	133851.58	158683.91	189138.47	219653.07	256583.30
Term deposits	413644.75	501792.50	583465.82	699766.73	800980.43
Borrowings	28790.89	41168.63	55856.28	71513.71	132413.81
RBI	836.10	5990.85	9261.36	6625.07	3650.27
Banks	5450.87	10507.25	9740.72	16787.97	20552.09
Fin. Institutions	7446.60	10728.19	12047.20	13880.20	14383.30
Debentures & bonds	2586.25	2588.41	8477.67	15474.84	60984.38
Government	988.20	180.94	1197.99	529.16	1130.10
Foreign borrowings	10856.75	10752.31	8899.79	9729.92	15536.14
Other borrowings	626.12	420.68	6231.55	8486.55	16177.53
Current liabilities	69217.78	82697.01	91727.32	100808.10	115529.20
Provisions	246.24	254.48	1414.41	2363.99	3977.58
Total liabilities	784899.64	940552.32	1105840.22	1297361.66	1541976.83
Debt/Equity	16.75	18.87	19.08	19.61	19.10
Contingent Liabilities	495942.96	476597.05	558645.08	710237.18	815876.03
Bills for collection	33026.25	48509.68	37971.13	53609.73	66489.26
Bills discounted	9918.76	1342.51	494.36	1099.68	418.95
Endorsement	41862.66	42549.01	46599.37	48788.50	51356.29
Disputed taxes	1402.27	1918.20	1405.78	1338.80	1138.74
Letters of credit	296.11	224.60	219.91	222.55	358.04
Ttal guarantees	57802.93	62939.17	66132.63	69435.26	84386.61
Forward exchange	351631.37	319108.95	405819.99	535742.66	611705.07
Future lease rent	2.61	4.93	1.91	0.00	23.07

Banks should clearly have a target on how much of long-term liabilities the bank should carry in the books. It would be difficult to say what the right mix is since it depends on lending opportunities in the economy and also banks' strategy. For instance some banks are aggressive in consumer finance and housing loan and others may be less interested in these segments but concentrate on trade finance. A bank with strong presence in metro might prefer consumer finance whereas a bank with large network has to look for several options. The risk profile of different classes of borrowing is different and hence banks need to have a clear goal on what type of lending programme they want to have. Once some broad understanding is reached, banks can target the amount to be raised through long-term sources. Normally, the cost of long-term liabilities is more than short-term since user is committing the money for a long period and bears the interest rate risk by locking in fixed interest rate. Banks, which are confident in managing the risk, can still go for medium to short-term borrowings.

Independent of the lending programme, the markets for deposit also determine the type of borrowings. As an intermediary agent, banks compete with other banks, corporate, and others for capital. The saving pattern of the people is again independent of the capital needs of the industry. For instance, when the future is not bright, suddenly everyone wants to save more but there may not be many takers for loan. When the future is bright, there will be more demand for credit, then people may be willing to spend more money than save. This imbalance sometimes makes the market more dynamic and allocates the capital more efficiently, but as a banker managing liabilities will be a tough task. When the lending units start committing money or accepting proposal, it would be difficult for the Treasury to find the money. While on the one hand, the Treasury will be borrowing money in the money market for short period, it will be pushing deposit units to attract more deposits to wind up short-term money market borrowings. Any lapse on the part of getting adequate deposits will lead to crisis in meeting short-term liabilities but treasury can't avoid such short-term borrowing in view of demand from the credit department. It can raise new short-term money to wind up old one, but it would be riskier.

Short-term Borrowings

Banks borrow money for short periods to match the short-term credit demands and also to meet liquidity consideration. Short-term funds can be sourced from institutions as well as individuals. Banks offer variety of short-term deposit schemes and offer slightly higher interest over and above the saving bank interest. Those who have temporary surplus cash and those who are planning for an investment in near future or waiting for investment opportunity would normally prefer such short-term deposits. Several large business houses also participate in such deposits. In addition to individuals and corporate, institutional market is very active for short-term borrowings. Banks and financial institutions actively participate in such market for borrowing and lending for several reasons. There is always imbalance in the financial flows in the banking sector. Some banks borrow or raise deposits more than what they need and some banks may have more need for capital than what they have had. Short-term funds are used to manage temporarily such imbalances and take sometime to complete the corrective action. Often such borrowings are also made to fulfil certain regulatory requirements like CRR and SLR conditions. Banks also borrow money to exploit some arbitrage opportunities or take active trading positions in government securities market or foreign exchange trading. There are several instruments through which banks borrow for short period. Some of the prominent instruments are call money borrowings, REPO transactions, inter-bank deposits, etc.

Treasury needs to closely monitor the liabilities, which has a large bearing on risk and liquidity of the bank. A change in market interest rate will affect existing liabilities as well as bank's ability to raise future liabilities. Similarly, changes in economic

performance might also affect the flow of funds. A good treasurer should have considerable amount of knowledge on inter-play of various factors and forecast clearly their impact, to manage the liabilities better than others.

Activity-3

- 1) Examine the sources of the funds for two large public sector and two large private sector banks. Examine the strategies of the banks in raising resources.

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- 2) With falling interest rates, banks are reluctant to accept long-term deposits but at the same time providing long-term loans. What is the risk involved in this strategy?

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2.5 MANAGING BANK ASSETS

Traditionally, 'Business Organisations' are the dominant borrowers of capital from banks and hence loans to business community form a major part of the assets of any bank. However, over the years, banks have expanded their activities to include non-business sectors. Today, banks lend money for agriculture and for various needs of the consumers. The nature of loans and assets are different between different kinds of loans and borrowers. Table-2.2 provides the details of the assets that the banking industry holds at the aggregate level. They differ in terms of amount required, duration, credit evaluation, risk, repayment, collateral, etc. In addition to lending, banks also invest in assets, which include debt, equity and currency. We can classify the assets under several categories but for the sake of consistency, we will discuss the assets also as long-term and short-term assets.

Table 2.2: Assets of Banking Industry

(Rs. in Crore)

	199803	199903	200003	200103	200203
Cash & bank balance	131206.82	169022.82	166800.37	191636.63	207130.56
Cash in hand	4451.70	5001.27	5679.15	6939.29	8121.51
Bank balance	13633.40	27196.45	32134.12	49862.03	67258.57
Balance outside India	46173.88	60651.70	49424.88	56477.26	51804.49
Balance with RBI	66947.84	76173.40	79562.22	78358.05	79945.99
Investments	270886.67	338064.10	414519.43	493633.00	591028.77
Government Sec	185598.77	228968.02	269685.92	343005.32	431509.82
Approved Sec	28701.52	26965.28	43901.97	32029.35	21913.80
Assisted Cos.	5.83	5.83	9.82	10.77	0.95
Subsidiaries	2504.97	2873.23	5253.42	2968.13	3411.33
Other companies	4402.80	4988.17	8099.45	8027.23	10558.54
Mutual funds	1827.11	2993.80	5463.65	5088.98	1088.29
Debentures / bonds	41575.99	62552.60	70290.87	81495.29	95548.23
Others	6269.68	8717.17	11814.33	21007.93	26997.81
Advances & loans	323931.47	368708.56	447991.51	529944.38	652204.90
Bills receivables	33812.96	36446.54	42804.78	49807.56	53704.27

Conceptual Framework

ST / demand adv	187981.61	202544.14	244619.72	288203.69	325593.93
Term advances	102136.90	129717.88	160567.01	191842.47	271959.15
Deferred tax assets	0.00	0.00	0.00	0.00	1910.47
Other assets / stocks	219.58	216.90	230.41	231.67	227.72
Receivables	45379.59	49681.64	60293.95	58060.71	64987.30
Future lease rent receivable	0.00	0.00	0.00	0.00	37.16
Gross fixed assets	18286.24	21730.80	24322.04	26697.40	32462.42
Less: cumulative depreciation	5329.31	7094.49	8570.51	10118.18	11925.09
Net fixed assets	12956.93	14636.31	15751.53	16579.22	20537.33
Intangible/ DRE not written off	10.62	25.78	34.89	6951.82	3949.78
Total assets	784899.64	940552.32	1105840.22	1297361.66	1541976.83

Long-term Assets

Any lending or investments aimed to be recovered after a year can be classified as long-term borrowing. Lending by banks for project financing or equipment financing will normally be repaid over a period of 5 to 10 years. Another major long-term lending is consumer financing and the repayment duration of many such consumer financing schemes exceed more than one year. Prominent consumer financing schemes of long term duration are vehicle financing, computer financing, etc. Some of the commercial and consumer financing is also arranged in the form of lease financing. Housing loan is yet another major activity of the banks where the repayment term varies from 5 to 20 years. In the Indian banking system, normally interest rates for such long-term loans are fixed. However, of late with falling interest rates, many borrowers prefer floating rate and banks have also started preferring the same in view of passing the risk to borrowers. As a student of finance, you might understand that anything fixed is considered risky in finance. The credit risk is also slightly more in the case of long-term assets in view of changing economic conditions of the borrowers. It is relatively easier to assess the short-term solvency of the borrower compared to long-term solvency. In view of high risk, normally, the documentation and covenants attached with all long-term loans are much elaborate and strict. Naturally, the level of monitoring is also high. In view of all such additional costs, the cost of lending for long-term borrowing is also more compared to short-term lending.

Short-term Assets

Banks invest in short-term assets to satisfy short-term demands of the market as well as deploying short-term surplus funds available. About 35% of the investments are held in the form government securities. Demand for short-term funds from Government and corporates is mainly on account of cash flow mismatch. For instance, just before the busy season or festival season, industries would need additional credit to meet additional working capital needs arising out of increased production and more credit sales. However, the cash flow improves once the collection process starts picking up towards the end of busy season. The additional working capital need is for short period. Similarly, the government also needs short-term working funds to meet various liabilities since revenue from tax collection and other sources is not uniform. Banks extend additional working capital loan and also invest in government treasury bills, which are essentially short-term assets. Banks also invest in short-term assets because of short-term nature of liabilities. For instance, Hindustan Lever deposits some Rs. 200 cr. in SBI for a period of 90 days, SBI may not be in a position to lend this amount for any long-term purpose. There is no assurance that HLL will renew the deposits. If there are more such funds, banks

would be willing to create short-term assets in the form of bill discounting, treasury investments or for its own treasury trading activities. Investment in financial securities though liquid can be classified into long-term or short-term based on the objectives for which the assets are purchased. Normally, investments purchased for trading is treated as short-term whereas long-term investments are called ‘investment held till maturity’.

As far as possible, the term structure of assets and liabilities are to be matched. What is the consequence of not matching the term structure? We will discuss more on this issue in the next part of this unit, Asset-Liability Management.

Activity-4

- 1) Examine any two new loan products from the angle of risk and return compared to existing products of similar nature?

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- 2) Refer Table 2.2 examine and comment on the changes of assets composition.

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2.6 ASSET-LIABILITY MANAGEMENT

As student of finance, we all know Assets are equal to Liabilities (which includes shareholders fund and liabilities to outsiders) because for every asset creation, we need to raise the capital from either equity owners or from others. However, this equation may get distorted when you break assets and liabilities under different categories and try to match them. For instance, long term liabilities and long-term assets may not be equal. For the purpose Asset-Liability Management (ALM), assets and liabilities are classified under two broad categories, namely on time scale and on rate scale.

As discussed earlier, it is possible to classify the assets and liabilities on time scale such as short-term and long-term or much more detailed manner like 1-day assets and liabilities, 1 week assets and liabilities, 3 months, 6 months, 1 year, 3 year, 5 years, etc. This is generally called in banking world as ‘buckets’ and the gap between ALM explains the level of gap risk. The gap causes risk because when the liabilities mature, there may not be simultaneous liquidation of assets, which may cause some kind of liquidity problem. Does it mean we need to keep the gap closed always? Not necessarily. There are two aspects in this. If the long-term liabilities are more than long-term assets and such surplus is used for short-term assets, then there is not much of a problem except loss of opportunity income. There may not be any liquidity pressure, the amount they will get from such investments will be relatively lower compared to cost of liabilities. So, one has to balance the level of excess value one can have on the long-term part. Aggressive banks would like to have a thin surplus on the long-term side whereas conservative banks would have large surplus to avoid liquidity problem.

The liquidity comfort comes at a cost and that is the second issue of gap management which will be costly for the bank. Long-term borrowings cost will be much higher compared to what short-term assets are offering as return. In other words, more than

liquidity, the real problem is ability to borrow at a lower cost than the lending rate. For example, if a bank accepts a deposit for 90 days at 5% and creates 180 days assets at 6%. The spread is 1%, but what is the risk in this structure. As long as the bank is able to renew the deposit or identify one more deposit holder, then there is no liquidity risk. It is possible to find a deposit at the end of 90 days but what is the cost to be incurred for such renewal is critical. The real risk is ability to borrow at a rate lower than 6%. For some reasons like tight money market condition, if the deposit rate increases to above 7%, the bank actually incurs a loss. So, the ability to take risk depends on the gap (here the gap is just one more renewal) and the spread between the two rates at the time of initial effort. For instance if the spread is 3% (i.e. lending rate is 10%), then bank can afford to take risk on such gap since unless the interest rate increases above 15%, there is no loss. Naturally, the probability of 90-day interest rate moving up from 6% to 15% within next 90 days is much lower.

In addition to time scale, assets and liabilities can be classified on rate structure. ***There are two types of lending and borrowing rates.*** One is ***fixed interest rate*** and other is ***floating interest rate***. Ideally, there should be a match between fixed rate borrowing and fixed rate lending and similarly, floating rate borrowing and floating rate lending. But it should be noted that the two activities (lending and borrowing) are performed in two different markets and normally by two different sets of people within the bank. It is difficult to expect any accurate matching. So, once the gap is identified, it has to be managed. The process of management includes keeping the gap as it is, if the belief is the gap will not work against the interest of bank. For instance, if the bank has borrowed floating rate and issued a fixed rate loan, then the gap is a problem if the interest rates are moving up. On the other hand, the bank can take risk if it expects interest rates are going to move down. The second option before the treasury is to adjust future borrowing and lending such that the gap is filled. Finally, the bank can actively manage the gap by taking some derivative transactions.

2.7 MANAGING LIQUIDITY AND RISK

The discussion on asset-liability management emphasis the importance of ***liquidity*** and ***risk***. Managing them is critical not only for the profitability of the bank but also long-term solvency of the bank. Liquidity gives comfort but it adds cost. Taking risk increases profit but it affects solvency. Therefore, the treasury needs to optimise the liquidity level and risk taking. Liquidity is improved by keeping large amount in liquid assets like investing in call-money market, treasury bills and in other such actively traded securities. The period of the security is not critical but trading volume is important. Of course, a change in interest rate affects long-term securities more than short-term securities though liquidity for both may be same. Liquidity is an issue even the Central Bank is worried. Reserve Bank of India thus requires banks to maintain certain part of the assets in form of cash (cash liquidity ratio) and some more in the form of government securities (statutory liquidity ratio). Depending on the bank's liquidity preferences, the treasury might maintain higher level of liquidity. Also, the liquidity level need not be uniform through out the year. It might get changed based on the liquidity needs at various points of time and also as a result of changes in general liquidity conditions of the market. At least, as a part of liquidity management, the treasury is expected to have a detailed guideline on the liquidity preferences under various conditions and ways to check whether liquidity is maintained to the desired level.

The most important activity of the Treasury is managing risk arising out of various activities of the bank. Taking risk is the only way to earn profit. And managing the risk is the only way to retain the profit and survive in the business. Banks take risk when they create assets. Some of the risks are related to assets and some of them arise

out of their linkage with liabilities. Credit risk is a risk associated with the assets and independent of other elements of risk. One way of managing risk is to put a cap on maximum lending for different types of credit rated borrowers or blanket denial for some kind of borrowers. However, if everyone rushes for AAA rated borrowers, then the competition itself will drive down the rates of such borrowers and naturally, it will also pull down the rates of other borrowers. So, it is desirable to spread the lending across different levels of credit rating. A simple way to manage the credit risk is to diversify the portfolio and reduce the exposure level by fixing some limit to each borrower, group of borrowers, industry and region. Periodical assessment and follow up will also be useful but that is typically done by the credit unit. Treasury job is mainly on developing policy and macro-level periodical assessment. However, treasury can securitize the credit portfolio and sell them as a part of managing the credit risk.

Non-credit risk is often managed through derivative instruments. Such derivative instruments include options, futures and swaps. Derivative transactions typically change the characteristics of the assets or liabilities or give some level of protection against the risk. For instance, if a bank enters into fixed interest rate borrowing, it loses when the interest rates are falling. It can either go for swap transaction through which it can change fixed characteristics of the deposit to floating characteristics or alternatively, it can take interest rate futures. If the treasury is interested only on downside risk (in this case only against falling interest rates), it can try options. There are so many variations in derivative products.

Often banks also enter into derivative transactions with their customers and in that process take the risk on the books of bank. Why customers walk into bank for such transactions? Obviously, they expect complete financial solutions from banks and moreover, banks are competent to handle such risk taking transactions. Since bank acts as an exchange, often it enters into two different transactions with two different customers and exactly of opposite nature and in that process, the whole risk gets cancelled. Here, without the knowledge of two parties, the bank has done intermediation job. Sometimes, such transactions might add risk to the bank and the treasury has to decide whether it has to carry the risk or liquidate them in the derivative market. Fortunately, derivative market is highly liquid and it is not much difficult to liquidate the positions.

Activity-5

- 1) Some of the new private sector banks are offering a facility in which balance above certain limits in your Savings Bank account is transferred to fixed deposit with a facility to automatically withdraw the amount at any time. Examine this investor-friendly product from the risk, return and ALM angles?

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- 2) For any given context, which you can identify yourself, how banks could use derivatives for managing liquidity and risk. You are encouraged to list one more such context.

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2.8 SUMMARY

Basic objectives of financial management are same whether it is manufacturing or service or banking industry. It is all about raising money, putting the same to optimum use and managing liquidity and risk of the business units. Since banks handle large volume of money, financial management is central of whole activity. Normally, the Treasury Division or department discharges the function of financial management. Treasury is central of any banking unit and it plans and monitors all financial movements. It plans for funds raising, funds deployment and manage liquidity and risk. Though funds raising and deployment substantially takes outside treasury, treasury plays a critical role in setting policy guidelines, fixing targets or limits and monitoring the same. Treasury also raises lot of funds from the institutional markets and also invests them in money market. As part of managing funds, Treasury also performs Asset-Liability Management as a preliminary step for liquidity and risk management. When it performs asset-liability matching exercise, it identifies areas of liquidity crisis and risk. There are several options before the treasury in improving the liquidity and managing the risk. It uses some of the concepts like securitization and derivatives in managing liquidity and risk.

2.9 SELF-ASSESSMENT QUESTIONS

1. Explain the scope and objectives of financial management in Banking
2. What are the important issues that the treasury departments will look into in the management of assets and liabilities?
3. What is Asset-Liability Management? Explain its significance in the context of bank financial management.
4. How does the asset-liability gap affect the return, liquidity and risk of the bank? Explain with few illustrations.
5. In recent years, Rupee is appreciating against dollar. Due to this, many banks are experiencing NRIs moving their Dollar account to Rupee account. How does this affect the overall financial management of the bank? Explain in the context of ALM and risk.

2.10 FURTHER READINGS

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