Understanding Asset–Liability Management (Full Balance Sheet Approach)

Checklist Description

This checklist provides advice on understanding asset liability management.

Definition

Asset–liability management, or ALM, is a means of managing the risk that can arise from changes in the relationship between assets and liabilities. ALM was originally pioneered by financial institutions in the 1970s as interest rates became increasingly volatile. This volatility had dangerous implications for financial institutions. Some, for example, had sold long-term guaranteed interest contracts—some guaranteed rates of around 16% for periods up to 10 years. However, when short-term interest rates subsequently fell, these institutions, such as the Equitable in the United States, were crippled. Prior to the 1970s, interest rates in developed countries varied little and thus losses accruing from asset–liability mismatches tended to be minimal.

Following the experience of Equitable and other institutions, financial firms increasingly focused on ALM, whereby they sought to manage balance sheets in order to maintain a mix of loans and deposits consistent with the firm’s goals for long-term growth and risk management. They set up ALM committees to oversee the ALM process. Today, ALM has been adopted by many corporations, as well as financial institutions. ALM now seeks to ascertain and control three types of financial risk: Interest rate risk, credit risk (the probability of default), and liquidity risk, which refers to the danger that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make a predetermined profit).

But ALM also now seeks to address other risks, such as foreign exchange risks and operational risks (covering areas such as fraud and legal risks, as well as physical or environmental risks). The techniques that are now applied by ALM practitioners have also developed, reflecting the growth of derivatives and other complex financial instruments. ALM now includes hedging, for example, whereby airlines will seek to hedge against movements in fuel prices and manufacturers will seek to mitigate the risk of fluctuations in commodity prices. Meanwhile, securitization has allowed firms to directly address asset–liability risk by removing assets or liabilities from their balance sheets.

Advantages

- ALM can help protect a financial institution or corporation against a variety of financial and nonfinancial risks.
- The mere process of identifying risks enables businesses to be better prepared to deal with these risks in the most cost-effective way.
- ALM ensures that a company’s capital and assets are used in the most efficient way.
- It can be used as a strategic and business tool to improve earnings.

Disadvantages

- ALM is only as good as the people on the ALM committee and the operational procedures that they follow.
- ALM can prove costly in terms of both the time required of employees and the investment required in management tools such as IT and techniques such as hedging.
Action Checklist

- Establish an ALM committee to oversee the process.
- Ensure the committee has the necessary tools and techniques for measuring and managing rate, credit, and funding risk. This should include a computer system that enables the monitoring of funding sources and credit exposures.
- Acquire a managerial accounting system that can control the information fed into the computer system.
- Establish a reward and penalty system to manage those employees who are taking rate, credit, funding and other risks.

Dos and Don’ts

**Do**

- Talk to one of the many consultancy firms that specialize in ALM, and that can advise on establishing an ALM committee and improving its performance.
- Ensure those appointed to the ALM committee have the necessary knowledge and experience to perform their tasks.
- Constantly monitor the performance of your committee.

**Don’t**

- Don’t seek to cut costs in terms of investing in management tools and personnel.
- Don’t forget that risks are constantly changing and developing. Make sure your ALM committee has the skills to deal with the latest developments.

More Info

**Books:**


**Article:**


**Website:**

- Institute of Risk Management (IRM): www.theirm.org

See Also

**Best Practice**

- Asset Liability Management for Pension Funds
- Managing Counterparty Credit Risk
- Managing Interest Rate Risk
- Minimizing Credit Risk
- Using Structured Products to Manage Liabilities

**Checklists**
• Identifying and Managing Exposure to Interest and Exchange Rate Risks

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