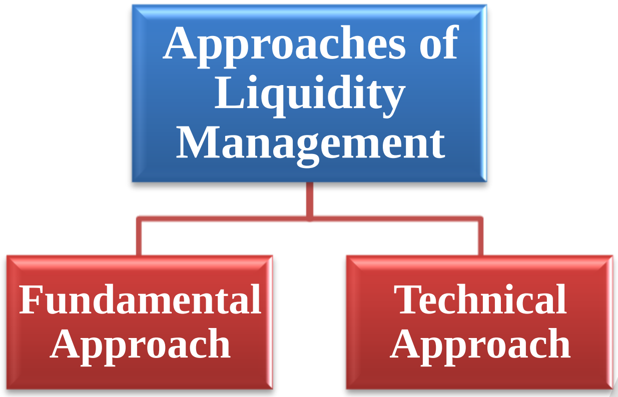
Approaches of Liquidity Management



These two methods distinguish from each other in their strategically approach to eliminate liquidity risk. While the fundamental approach aims to ensure the liquidity for long run sustenance of the bank, the technical approach targets the liquidity in the short run. Due to these features, the two approaches supplement each other in eliminating the liquidity risk and ensuring profitability.

1. Fundamental Approach

Since long run sustenance is driving factor in this approach, the bank tries to tackle /eliminate the liquidity risk in the long run by basically controlling its assets-liability position. A prudent way of tackling this situation can be by adjusting the maturity of assets and liabilities or by diversifying and broadening the sources of funds.

The two alternatives available to control the liquidity exposure under this approach are **Asset Management and Liability Management**. This implies that liquidity can be imparted into the system either by liability creation or by asset liquidation, which eve suite the situation.

1. **Asset Management:** Asset management is to eliminate liquidity risk by holding near cash assets i.e. those assets, which can be turned into cash whenever required. For instance, sale of securities from the investment portfolio can enhance liquidity. When asset management is resorted to, the liquidity requirements are generally met from primary and secondary reserves. Primary reserves refer to cash assets held to meet the statutory cash reserve requirements (CRR) and other operating purposes. Though primary reserves do not serve the purpose of liquidity management for long period, they can be held as second line of defense against daily demand for cash. This is possible mainly due to the flexibility in the cash reserve balances (statutory cash reserves are required to be maintained only on a daily average basis for a reserve maintenance period). However, most of the liquidity is generally attained from the secondary reserves, which include those assets held primarily for liquidity purposes. These secondary reserves are highly liquid assets, which when converted into cash

carry little risk of loss in their value. Further, they can also be converted into cash prior to their maturity at the discretion of the management. When asset management is resorted to for liquidity, it will be through liquidation of secondary reserves. Assets that fall under this category generally take the form of unsecured marketable securities. The bank can dispose these secondary reserves to honor demands for deposit withdrawals, adverse clearing balances or any other reasons.

2. **Liability Management:** Converse to the asset management strategy is liability management, which focuses on the sources of funds. Here the bank is not maintaining any surplus funds, but tries to achieve the required liquidity by borrowing funds when the need arises. The underlying implications of this process will be that the bank mostly will be investing in long-term securities/loans (since the short-term surplus balance will mostly be in a deficit position) and further, it will not depend on its liquidity position/surplus balance for credit accommodation/business proposals. Thus in liability management a proposal may be passed even when there is no surplus balance since the bank intends to raise the required funds from external sources. Though it involves a greater risk for the bank, it will also fetch higher yields due to the long-term investments. However, sustenance of such high spreads will depend on the cost of borrowing. Thus, the cost and the maturity of the instrument used for borrowing funds play a vital role in liability management. The bank should on the one hand be able to raise funds at low cost and on the other hand ensure that the maturity profile of the instrument does not lead to or enhance the liquidity risk and the interest rate risk. Of the two strategies available in fundamental approach, it is understood that while asset management tries to answer the basic question of how to deploy the surplus to eliminate liquidity risk, liability management tries to achieve the same by mobilizing additional funds.

2. Technical Approach

As mentioned earlier, technical approach focuses on the liquidity position of the bank in the short run. Liquidity in the short run is primarily linked to the cash flows arising due to the operational transactions. Thus, when technical approach is adopted to eliminate liquidity risk, it is the cash flows position that needs to be tackled. The bank should know its cash requirements and the cash inflows and adjust these two to ensure a safe level for its liquidity position.

Working Funds Approach and the Cash Flows Approach are the two methods to assess the liquidity position in the short run. Of these two approaches, the former concentrates on the actual cash position and depending on the factual data, it forecasts the liquidity requirements. The latter approach goes a step forward and forecasts the cash flows i.e. estimates any change in the deposits withdrawals credit accommodation etc. Thus apart from assessing the liquidity requirements, it also advises the bank on its investments and borrowing requirements well in advance.