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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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- Sharma T., Kwatra, G. (2008) Effectiveness of Social Advertising: A Study of Selected Campaigns, Corporate Social Responsibility, Edited by David Crowther & Nicholas Capaldi, Ashgate Research Companion to Corporate Social Responsibility, Chapter 15, pp 287-303.

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- Schemenner, R.W., Huber, J.C. and Cook, R.L. (1987), "Geographic Differences and the Location of New Manufacturing Facilities," Journal of Urban Economics, Vol. 21, No. 1, pp. 83-104.

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- Garg, Sambhav (2011): "Business Ethics" Paper presented at the Annual International Conference for the All India Management Association, New Delhi, India, 19–22 June.

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- Kumar S. (2011): "Customer Value: A Comparative Study of Rural and Urban Customers," Thesis, Kurukshetra University, Kurukshetra.

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LIQUIDITY RISKS MANAGEMENT PRACTICES BY COMMERCIAL BANKS IN BANGLADESH: AN EMPIRICAL STUDY

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ABSTRACT

This study of liquidity risks management processes is essentially an investigation of how banks manage liquidity risk is associated with solvency uncertainty at the renouncing stage. In such a case, the procedure outlined above is adopted to the risk considered so as to standardize measured, constrain and manage the risks. To illustrate how this achieved, this review of firm-level risk management begins with a discussion of risk management controls in this area. To insure, banks can accumulate liquid assets, or enhance transparency to facilitate renouncing. A liquidity buyer provides complete insurance against small liquidity shocks, while transparency over partial insurance against large ones as well. We observes that, due to leverage, banks can under-invest in both liquidity and transparency, and within that have a bias towards liquidity as it preserves internal control.

KEYWORDS
Core risks, Liquidity risks, Liquidity risks management, Risks management committee.

1. INTRODUCTION AND VIEWS OF LIQUIDITY RISKS

Banks perform maturity transformation and insure public's liquidity needs, but in process become exposed to liquidity risk (Diamond and Dybvig, 1983). When renouncing frictions prevent a solvent bank from covering a liquidity shortage, it may go bankrupt despite having valuable long-term assets. Most recent bank liquidity events in developed countries were associated with increased solvency concerns. Global scanning and the effect of globalization has had a significant impact on all types of business entities and their activities have become global by nature, thereby affecting the greater part of economic life (ohmac,1990, Barnet and Cavanagh,1994, Brecher Costello,1994). Due to globalization of banking business, banks are new exposed to diversified and complex risks. As a result, effective management of such risks has been core aspects of establishing good governance in banking in order to ensure sustainable performance. Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty, while the types and degree of risks an organization may be exposed to depend upon a number of factors such as its size, complexity of business activities, volume etc. In banking sector regular and prime activities are the management of risks. Bank accept risks in order to earn profit, they must make a comprehensive balance alternative strategies in terms of their risks characteristics with the goal of maximizing shareholders wealth. In doing so, banks recognize that there are different types of risks and that the impact of a particulars investment policy. In recognition of the importance of an effective risks management system and policies Bangladesh Bank as guardian of all financial institutions has issued guidelines on managing core risks in banking sector. Generally the core risks are categories into five broad classes such as, credit risks, assets and liability or balance sheet risks, foreign exchange risks, liquidity risks, and money laundering risks. The core risks and benefits of globalization distributed unevenly developing countries facing tremendous difficulties in meeting the challenge globalization, according to the literature, which suggested that the current process of globalization is unsustainable for us in the long run unless we introduce new ways and dynamic policies able to govern it (Tisdell, 2001). In responding the core risks in the banking sector and meet its obligation and commitment as they fall due commercial bank have been made the strengthen structure for liquidity risks management. To survive, a bank must be able to support itself with own funds for the duration of liquidity stress, and/or alleviate the markets concerns over its solvency to regain access to funds as soon as possible.

However, liquidity risk is the potential loss to an institution arising from either its inability to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable cost or losses and leading to bankruptcy or rise in funding cost. Liquidity is the solvency capacity of business entities or bank and which has special reference to the degree of readiness in which assets can be converted into cash without any loss. Liquidity risk is the danger of having insufficient cash to meet a bank's obligations when due (Rose, Peter S.2005) Liquidity risks also include our inability to liquidate any asset at reasonable price in a timely manner. Banks traditionally use the statutory liquidity reserve and their borrowing capacity in the volatile inter-bank money market as the source of liquidity. But a conscious approach to measure and monitor the liquidity is somewhat lacking in our market. We can learn and draw benefit by showing the best practices, tools and techniques of liquidity management demonstrate the types of liquidity risks in such a way:

Funding risk: it is the need to replace net outflows of funds whether due to withdrawal of retail deposits or non-renewal of wholesale funds.

Time risk: time risk is the need to compensate for non-receipt of expected inflows of funds, e.g. when a borrower fails to meet his repayment commitments.

Call risk: call risk is the need to find fresh funds when contingent liabilities become due. Call risk also includes the need to be undertaking new transactions when desirable.

And management concerned about the following liquidity factors:

Some factors increasing liquidity risk, these are:

- Erosion of confidence in a bank within the marketplace because of earnings difficulties or other reasons.
- Depending on one market or on a few counter-parties for deposits.

- Unstable financial markets and
- Extensive 'short' borrowing or 'long' lending operations.

Some factors are reducing liquidity risk, these are:

- Availability of related party funding
- Maintenance of a high level of liquid assets
- Government deposit insurance, if any and
- Maintenance of a closely matched, as possible, maturity structure between assets and liabilities.

Early Warning indicators of liquidity risk: An incipient liquidity problem may initially reveal in the bank's financial monitoring system as a downward trend with potential long-term consequences for earnings or capital. Given below are some early warning indicators that not necessarily always lead to liquidity problem for a bank; however these have potential to ignite such a problem. Consequently management needs to watch carefully such indicators and exercise further scrutiny/analysis wherever it deems appropriate.

Examples of such internal indicators are:

a) A negative trend or significantly increased risk in any area or product line.
b) Concentrations in either assets or liabilities.
c) Deterioration in quality of credit portfolio.
d) A decline in earnings performance or projections.
e) Rapid asset growth funded by volatile large deposit.
f) A large size of off-balance sheet exposure.
g) Deteriorating third party evaluation about the bank

2. OBJECTIVES OF THE STUDY

The ultimate objective of the study is to review the theoretical and empirical knowledge as risk management as well as liquidity risk management is a discipline at the core of every financial institution and encompasses all the activities that affect its risk profile and the economic consequences of financial solvency and performance of risk management process. To achieve this main objective, the following specific objectives of the study are also identified while liquidity risks involve measurement, monitoring and controlling risks to ensure that:

a) The individuals who take or manage risks clearly understand it.
b) The organization's risk exposure is within the limits established by BOD.
c) Limit of Sufficient capital as a buffer is available to take risks.

3. METHODOLOGY OF THE STUDY

Various business journals and research papers, diagnostic study reports and newspaper articles have been surveyed in making this study significantly fruitful, transparent and objective oriented. However, this paper has been conducted mainly on the basis of literature survey and desk work of secondary information. Meanwhile few academicians, qualified chartered accountants and cost and management accountants (public practice or not) and senior bank management personnel have been personally consulted with in order to have their thoughts and views in this regards.

4. DESIGN OF THE STUDY

4.1. PREPARATION FOR BASEL II ACCORD – STRENGTHENING RISK MANAGEMENT SYSTEM AND CAPITAL BASE OF THE BANK

In order to make the banks in Bangladesh more shock absorbent as well as to cope with international best practice for risk management and, a sound and robust banking industry, Bangladesh Bank has taken measures to implement BASEL II from January 2009.

BASEL Committee on Banking Supervision published a more comprehensive new package on capital adequacy requirement known as BASEL II for strengthening the capital adequacy, improving supervisory system to assess the adequacy of capital based on a thorough review of risks, reinforce risk management system and market discipline with the ultimate objective of having strong capital base that are commensurate with risk profile of the Bank comprising credit risk, market risk and operational risk that can ensure long term stability and solvency of banking company and banking sector as a whole. A National Steering Committee comprising senior officials from banking industry, Bangladesh Bank and Chartered Accountant Firms has been constituted. Furthermore, a Coordination Committee and a Basel II implementation Cell have been established. In the meantime, Bangladesh Bank has done two studies one is self-audit on Basel core principles for effective Bank supervision and the second one is quantitative impact study in order to assess readiness of the banks for implementation of Basel II.

Under standardized approach, Basel II requires the recognition of External Credit Assessment Institutions for this a guideline has been prepared by BB and recognition process of credit rating agencies is under process. Bangladesh Bank has already issued Guidelines on Risk based capital adequacy for banks (revised regulatory capital framework in line with BASEL II) vide BRPD Circular No. 09 dated December 31, 2008.

In line with Bangladesh Bank requirement, the Bank has already formed a Basel II Implementation Unit to ensure smooth and timely implementation of Basel II Accord. Capacity building measures are underway so that the Bank is fully prepared to adopt the Accord in 2009.

4.2. LIQUIDITY RISKS MANAGEMENT PROCESSES

A bank has adequate liquidity when it can obtain sufficient funds, either by increasing liabilities or by converting assets, promptly and at a reasonable cost. Liquidity is essential in all banks to compensate for expected and unexpected balance sheet fluctuation and to provide funds for growth. The price of liquidity is a function of market conditions and market perception of the risks, both interest rate and credit risks, reflected in the banks balance sheet and off- balance sheet activities. It is the policy of the Bank to maintain adequate liquidity at all times and in both local and foreign currencies. Liquidity risks are managed on a short, medium and long-term basis. There are approved limits for credit-deposit ratio, liquid assets to total assets ratio, maturity mismatch, commitments for both in on-balance sheet and off-balance sheet items and borrowing from money market to ensure that loans & investments are funded by stable sources, maturity mismatches are within limits and that cash inflow from maturities of assets, customer deposits in a given period exceeds cash outflow by a comfortable margin even under a stressed liquidity scenario. However, an effective liquidity risk management includes systems to identify measure, monitor and control its liquidity exposures. Management should be able to accurately identify and quantify the primary sources of a bank's liquidity risk in a timely manner. To properly identify the sources, management should understand both existing as well as future risk that the institution can be exposed to. Management should always be alert for new sources of liquidity risk at both the transaction and portfolio levels.

- A liquidity risk management involves not only analyzing banks on and off-balance sheet positions to forecast future cash flows but also how the funding requirement would be met. The later involves identifying the funding market the bank has access, understanding the nature of those markets, evaluating banks current and future use of the market and monitor signs of confidence erosion. Managing liquidity risk
- The formality and sophistication of risk management processes established to manage liquidity risk should reflect the nature, size and complexity of an institution's activities. Sound liquidity risk management employed in measuring, monitoring and controlling liquidity risk is critical to the viability of any institution. Institutions should have a thorough understanding of the factors that could give rise to liquidity risk and put in place mitigating controls.
- Management Information System and Liquidity Risks Management: Key elements of an effective risk management process include an efficient MIS, systems to measure, monitor and control existing as well as future liquidity risks and reporting them to senior management.
- An effective management information system (MIS) is essential for sound liquidity management decisions. Information should be readily available for day to day liquidity management and risk control, as well as during times of stress. Data should be appropriately consolidated, comprehensive yet succinct, focused, and available in a timely manner. Ideally, the regular reports a bank generates will enable it to monitor liquidity during a crisis; managers would

simply have to prepare the reports more frequently. Managers should keep crisis monitoring in mind when developing liquidity MIS. There is usually a trade -off between Managing liquidity risk accuracy and timeliness. Liquidity problems can arise very quickly, and effective liquidity management may require daily internal reporting. Since bank liquidity is primarily affected by large, aggregate principal cash flows, detailed information on every transaction may not improve analysis.

- Management should develop systems that can capture significant information. The content and format of reports depend on a bank's liquidity management practices, risks, and other characteristics. However, certain information can be effectively presented through standard reports such as "Funds Flow Analysis," and "Contingency Funding Plan Summary". These reports should be tailored to the bank's needs. Other routine reports may include a list of large funds providers, a cash flow or funding gap report, a funding maturity schedule, and a limit monitoring and exception report. Day-to-day management may require more detailed information, depending on the complexity of the bank and the risks it undertakes. Management should regularly consider how best to summarize complex or detailed issues for senior management or the board. Beside s other types of information important for managing day-to-day activities and for understanding the bank's inherent liquidity risk profile include:

a) Asset quality and its trends.
b) Earnings projections.
c) The bank's general reputation in the market and the condition of the market itself.
d) The type and composition of the overall balance sheet structure.
e) The type of new deposits being obtained, as well as its source, maturity, and price. As far as information system is concerned, various units related to treasury activities, the dealing, the treasury operation & risk management cell/department should be integrated. Furthermore, management should ensure proper and timely flow of information among front office, back office and middle office in an integrated manner; however, their reporting lines should be kept separate to ensure independence of these functions.

4.3. LIQUIDITY RISK MEASUREMENT AND MONITORING

- An effective measurement and monitoring system is essential for adequate management of liquidity risk. Consequently banks should institute systems that enable them to capture liquidity risk ahead of time, so that appropriate remedial measures could be prompted to avoid any significant losses. It needs not mention that banks vary in relation to their liquidity risk (depending upon their size and complexity of business) and require liquidity risk measurement techniques accordingly. For instance banks having large networks may have access to low cost stable deposit, while small banks have significant reliance on large size institution deposits. However, abundant liquidity does not obviate the need for a mechanism to measure and monitor liquidity profile of the bank. An effective liquidity risk measurement and monitoring system not only helps in managing liquidity in times of crisis but also optimize return through efficient utilization of available funds. Discussed below are some (but not all) commonly used liquidity measurement and monitoring techniques that may be adopted by the banks.
- Contingency Funding Plans; In order to develop a comprehensive liquidity risk management framework, institutions should have way out plans for stress scenarios. Such a plan commonly known as Contingency Funding Plan (CFP) is a set of policies and procedures that serves as a blue print for a bank to meet its funding needs in a Managing liquidity risk timely manner and at a reasonable cost. A CFP is a projection of future cash flows and funding sources of a bank under market scenarios including aggressive asset growth or rapid liability erosion. To be effective it is important that a CFP should represent management's best estimate of balance sheet changes that may result from a liquidity or credit event. A CFP can provide a useful framework for managing liquidity risk both short term and in the long term. Further it helps ensure that a financial institution can prudently and efficiently manage routine and extraordinary fluctuations in liquidity.
- Cash Flow Projections: At the basic level banks may utilize flow measures to determine their cash position. A cash flow projection estimates a bank's inflows and outflows and thus net deficit or surplus (GAP) over a time horizon. The contingency funding plan discussed previously is one example of a cash flow projection. Not to be confused with the re-pricing gap report that measures interest rate risk, a behavioral gap report takes into account bank's funding requirement arising out of distinct sources on different time frames. A maturity ladder is a useful device to compare cash inflows and outflows both on a day-to-day basis and over a series of specified time periods. The number of time frames in such maturity ladder is of significant importance and up to some extent depends upon nature of bank's liability or sources of funds. Banks, which rely on short- term funding, will concentrate primarily on managing liquidity on very short term. Where as, other banks might actively manage their net funding requirement over a slightly longer period. In the short- term, bank's flow of funds could be estimated more accurately and also such estimates are of more importance as these provide an indication of actions to be taken immediately. Further, such an analysis for distant periods will maximize the opportunity for the bank to manage the GAP well in advance before it crystallizes. Consequently banks should use short time frames to measure near term exposures and longer time frames thereafter. It is suggested that banks calculate daily GAP for next one or two weeks, monthly Gap for next six month or a year and quarterly thereafter. While making an estimate of cash flows, following aspect needs attention

a) The funding requirement arising out of off- Balance sheet commitments also need to be accounted for.
b) Many cash flows associated with various products are influenced by interest rates or customer behavior. Banks need to take into account behavioral aspects instead of contractual maturity. In this respect past experiences could give important guidance to make any assumption.
c) Some cash flows may be seasonal or cyclical.
d) Management should also consider increases or decreases in liquidity that typically occur during various phases of an economic cycle.

- **Liquidity Ratios and Limits:** Banks may use a variety of ratios to quantify liquidity. These ratios can also be used to create limits for liquidity management. However, such ratios would be meaningless unless used regularly and interpreted taking into account qualitative factors. Ratios should always be used in conjunction with more qualitative information about borrowing capacity, such as the likelihood of increased requests for early withdrawals, decreases in credit lines, decreases in transaction size, or shortening of term funds available to the bank. To the extent that any asset-liability management decisions are based on financial ratios, a bank's asset-liability managers should understand how a ratio is constructed, the range of alternative information that can be placed in the numerator or denominator, and the scope of conclusions that can be drawn from ratios. Because ratio components as calculated by banks are sometimes inconsistent, ratio-based comparisons of institutions or even comparisons of periods at a single institution can be misleading.

i. **Cash Flow Ratios and Limits.** One of the most serious sources of liquidity risk comes from a bank's failure to "roll over" a maturing liability. Cash flow ratios and limits attempt to measure and control the volume of liabilities maturing during a specified period of time.
ii. **Liability Concentration Ratios and Limits.** Liability concentration ratios and limits help to prevent a bank from relying on too few providers or funding sources. Limits are usually expressed as either a percentage of liquid assets or an absolute amount. Sometimes they are more indirectly expressed as a percentage of deposits, purchased funds, or total liabilities.
iii. **Other Balance Sheet Ratios.** Total loans/total deposits, total loans/total equity capital, borrowed funds/total assets etc are examples of common ratios used by financial institutions to monitor current and potential funding levels.

- **Accounting estimates and Liquidity ratios:** In addition to the statutory limits of liquid assets requirement and cash reserve requirement, the board and senior management should establish limits on the nature and amount of liquidity risk they are willing to assume. The limits should be periodically reviewed and adjusted when conditions or risk tolerances change. When limiting risk exposure, senior management should consider the nature of the bank's strategies and activities, its past performance, the level of earnings, capital available to absorb potential losses, and the board's tolerance for risk. Balance sheet complexity will determine how much and what types of limits a bank should establish over daily and long-term horizons. While limits will not prevent a liquidity crisis, limit exceptions can be early indicators of excessive risk or inadequate liquidity risk management. However, Most of the banks estimate liquidity based on the ratios on a specific date. There are two types of liquidity indicators:

a) Asset based or Stored Liquidity Ratios, b) Liability based or Purchased Liquidity Ratios.

a) Asset based or Stored Liquidity Ratios:

1) Cash position indicators = Cash + Deposits / Total Assets

2) Liquid Securities Indicators = Govt. Securities / Total Securities

3) Risk less Assets Position = Cash+ Deposits+ Govt. Securities / Total Assets

4) Net Treasury Funds Position = Balance of Reserves with Central Bank / Total Assets

5) Liquidity Assets Ratio = Cash+ Reserves+ Govt. Securities / Total Assets

6) Capacity Ratio = Net Loan + Lease or Rent / Total Assets

7) Pledged Securities Ratio = Pledged Securities / Total Securities Holdings

b) Liability based or Purchased Liquidity Ratios:

1) Hot Money deposit = Withdraw able Hot Money Deposits / Total Hot Money Deposits

2) Short- term Deposit to Assets= Short- term Deposits / Total Assets

3) Short- time Investments to Sensitive Liabilities = Short- time Investments / Sensitive Liabilities

4) Deposits Brokerage Index = Brokerage deposits / Total Assets

5) Core Deposits Ratio = Core Deposits / Total Assets

6) Deposits Composition Ratio = Current Deposits / Term Deposits

7) Transaction Deposits Ratio = Transaction Deposits / Non- transaction able Deposits

- Internal Controls and Liquidity risks: In order to have effective implementation of policies and procedures, banks should institute review process that should ensure the compliance of various procedures and limits prescribed by senior management. Persons independent of the funding areas should perform such reviews regularly. T he bigger and more complex the bank, the more thorough should be the review. Reviewers should verify the level of liquidity risk and management's compliance with limits and operating procedures. Any exception to that should be reported immediately to senior management / board and necessary actions should be taken. Senior management and the board, or a committee thereof, should receive reports on the level and trend of the bank's liquidity risk at least quarterly. A recent trend in liquidity monitoring is incremental reporting, which monitors liquidity through a series of basic liquidity reports during stable funding periods but ratchets up both the frequency and detail included in the reports produced during periods of liquidity stress. From these reports, senior management and the board should learn how much liquidity risk the bank is assuming, whether management is complying with risk limits, and whether management's strategies are consistent with the board's expressed risk tolerance. The sophistication or detail of the reports should be commensurate with the complexity of the bank.

4.4. TECHNIQUES OF LIQUIDITY RISK MEASUREMENT

- Liquidity Tracking: Measuring and managing liquidity needs are vital for effective of a bank. By assuring the bank's ability to meet its liabilities as they become due, liquidity management can reduce the profitability of an adverse situation. The importance of liquidity transcends individual institutions, as liquidity shortfall in a bank can have repercussions on the entire system. The ALCO should measure not only the liquidity positions of the bank on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered being liquid, such as government securities and money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirement, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool.
- Time Buckets: The maturity profile could be used for measuring the future cash flows of a financial institute in different time buckets. The time buckets shall be distributed as under:

a) 1 day to 30/31 days(one month);
b) Over one month and up to two months;
c) Over two months and up to three months;
d) Over three months and up to six months;
e) Over six months and up to one year;
f) Over one year and up to three years;
g) Over three years and up to five years;
h) Over five years and up to seven years;
i) Over seven years and up to ten years;
j) Over ten years;

- CRR and SLR Requirement: Every bank is required to maintain a Cash Reserve Ratio (CRR) of 5% on the basis on its customer deposits. The CRR is maintained with the non- interest bearing current account with the Central Bank. In addition, every financial institute is required to maintain a Statutory Liquidity Reserve (SLR) of 18% including CRR on all its liabilities. There is no restriction on where these SLR will be maintained. The banks holding deposits are given freedom to place the mandatory securities in any time buckets as suitable for them. These SLRs shall be kept with banks and financial institutions for different maturities.
- Time Bucket Mismatch: Within each time bucket, there could be mismatches depending on cash inflows and outflows. While the mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus should be on the short-term mismatches viz., 1-90 days. The cumulative mismatches (running total) across all time buckets shall be monitored in accordance with internal prudential limits set by ALCO from time to time. The mismatches (negative gap) during 1-90 days, in normal course, should not exceed 15% of the cash outflows in this time buckets. If the bank, in view of current asset-liability profile and the consequential structure mismatches, needs higher tolerance level, it could operate with higher limit sanctioned by ALCO giving specific reasons on the need for such higher limit.
- Statement of Structural Liquidity: The statement of structural liquidity shall be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability will be a cash outflows while a maturity asset will be a cash inflows. While determining the likely cash inflows/ outflows, every financial institute has to make a number of assumptions according to its asset-liability profiles. While determining the tolerance levels, the bank should take into account all relevant factors based on its asset-liability base, nature of business, future strategies, etc. The

ALCO must ensure that the tolerance levels are determined keeping all necessary factors in view and further refined with experience gained in liquidity management.

- Short-term Dynamic Liquidity: In order to enable the bank to monitor its short-term liquidity on a dynamic basis over a time horizon spanning from 1 day to 6 months, ALCO should estimate short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.
- Liquidity Risk Strategy: The liquidity risk strategy defined by board should enunciate specific policies on particular aspects of liquidity risk management, such as: **Composition of Assets and Liabilities**. The strategy should outline the mix of assets and liabilities to maintain liquidity. Liquidity risk management and asset/liability management should be integrated to avoid steep costs associated with having to rapidly reconfigure the asset liability profile from maximum profitability to increased liquidity. **Diversification and Stability of Liabilities**. A funding concentration exists when a single decision or a single factor has the potential to result in a significant and sudden withdrawal of funds. Since such a situation could lead to an increased risk, the Board of Directors and senior management Managing liquidity risk should specify guidance relating to funding sources and ensure that the bank have a diversified sources of funding day-to-day liquidity requirements. An institution would be more resilient to tight market liquidity conditions if its liabilities were derived from more stable sources. To comprehensively analyze the stability of liabilities/funding sources the bank need to identify:

a) Liabilities that would stay with the institution under any circumstances;
b) Liabilities that run-off gradually if problems arise; and
c) That run-off immediately at the first sign of problems.

ACCESS TO INTER-BANK MARKET

The inter-bank market can be important source of liquidity. However, the strategies should take into account the fact that in crisis situations access to inter bank market could be difficult as well as costly. The liquidity strategy must be documented in a liquidity policy, and communicated throughout the institution. The strategy should be evaluated periodically to ensure that it remains valid. The institutions should formulate liquidity policies, which are recommended by senior management/ALCO and approved by the Board of Directors (or head office). While specific details vary across institutions according to the nature of their business, the key elements of any liquidity policy include:

a) General liquidity strategy (short- and long-term), specific goals and objectives in relation to liquidity risk management, process for strategy formulation and the level within the institution it is approved;
b) Roles and responsibilities of individuals performing liquidity risk management functions, including structural balance sheet management, pricing, marketing, contingency planning, management reporting, lines of authority and responsibility for liquidity decisions;
c) Liquidity risk management structure for monitoring, reporting and reviewing liquidity;
d) Liquidity risk management tools for identifying, measuring, monitoring and controlling liquidity risk (including the types of liquidity limits and ratios in place and rationale for establishing limits and ratios);
e) Contingency plan for handling liquidity crises.

- To be effective the liquidity policy must be communicated down the line throughout in the organization. It is important that the Board and senior management/ALCO review these policies at least annually and when there are any material changes in the institution's current and prospective liquidity risk profile. Such changes could stem from internal circumstances (e.g. changes in business focus) or external circumstances (e.g. changes in economic conditions). Reviews provide the opportunity to fine tune the institution's liquidity policies in light of the institution's liquidity management experience and development of its business. Any significant or frequent exception to the policy is an important barometer to gauge its effectiveness and any potential impact on banks liquidity risk profile.
- Institutions should establish appropriate procedures and processes to implement their liquidity policies. The procedural manual should explicitly narrate the necessary operational steps and processes to execute the relevant Managing liquidity risk liquidity risk controls. The manual should be periodically reviewed and updated to take into account new activities, changes in risk management approaches and systems.

CONCLUDING REMARKS

Liquidity risk is considered a major risk for banks. It arises when the cushion provided by the liquid assets are not sufficient enough to meet its obligation. In such a situation banks often meet their liquidity requirements from market. However the conditions of funding through market depend upon liquidity in the market and borrowing institution's liquidity. Accordingly an institution short of liquidity may have to undertake transaction at heavy cost resulting in a loss of earning or in worst case scenario the liquidity risk could result in bankruptcy of the institution if it is unable to undertake transaction even at current market prices. Banks with large off-balance sheet exposures or the banks, which rely heavily on large corporate deposit, have relatively high level of liquidity risk. Further the banks experiencing a rapid growth in assets should have major concern for liquidity.

Liquidity risk may not be seen in isolation, because financial risk are not mutually exclusive and liquidity risk often triggered by consequence of these other financial risks such as credit risk, market risk etc. For instance, a bank increasing its credit risk through asset concentration etc may be increasing its liquidity risk as well. Similarly a large loan default or changes in interest rate can adversely impact a bank's liquidity position. Further if management misjudges the impact on liquidity of entering into a new business or product line, the bank's strategic risk would increase.

Bank might be in the form of an Asset Liability Committee (ALCO) comprised of senior management, the treasury function or the risk management department. However, usually the liquidity risk management is performed by an ALCO. Ideally, the ALCO should comprise of senior management from each key area of the institution that assumes and/or manages liquidity risk. It is important that these members have clear authority over the units responsible for executing liquidity-related transactions so that ALCO directives reach these line units unimpeded. The ALCO should meet monthly, if not on a more frequent basis. Generally responsibilities of ALCO include developing and maintaining appropriate risk management policies and procedures, MIS reporting, limits, and oversight programs. ALCO usually delegates day-to-day operating responsibilities to the bank's treasury department. However, ALCO should establish specific procedures and limits governing treasury operations before making such delegation. Since liquidity risk management is a technical job requiring specialized knowledge and expertise, it is important that senior management/ALCO not only have relevant expertise but also have a good understanding of the nature and level of liquidity risk assumed by the institution and the means to manage that risk.

Banks have good reason to worry about risk management; they continue to be caught by dramatic turns in the economic cycle that arrive without much warning. Even if these turns could be predicted in advance, many activities are not yet liquid enough to remove or hedge the risk. The recent crises in Asia and emerging markets indicate that banks worldwide continue to have difficulty in dealing with illiquidity. Moreover, they appear to be caught in a vicious cycle that moves between rapid growth in the 'good' times and virtual standstill when a crisis hits home. To break through this cycle, banks need to adopt a more structured and top-down approach to risk management. The challenge is to make strategic decisions on the desired shape of the institution and ensure that there is a sound balance between businesses such as wholesale and consumer banking. Typically, the decision to participate in a particular business and allocate resources to that business assumes a large part of the risk. Once that decision is made, the bank should be prepared to incur stress related losses from time to time. As long as the risk profile is in balance and well diversified, the institution can absorb these as part of its normal business. Once the risk appetite has been defined, the focus shifts to day-to-day decision making. To support the lines of business and front-line staff in this process, banks are increasingly adopting risk-adjusted profitability measures.

Now a day, EVA has become one of the dominant performance indicators and has been fully integrated into the executive remuneration scheme. EVA provides a natural incentive to focus on risk. It provides a more constant message regarding the risk of volatile activities, relative to other measures, and in the best parts of the cycle serves as a reminder that the underlying risk can still be significant. It also supports strategies that optimize the use of capital as a scarce resource. Conversely, during a downturn it provides a more balanced picture of the value of the business. This ensures that there is as much focus on protecting the franchise as there is on eliminating unacceptable risks.

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