



“MANAGEMENT OF LIQUIDITY RISK IN THE INDIAN BANKING SECTOR-A CASE STUDY OF UCO BANK”

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Abstract

Risk Management has got much importance in the Indian Economy during this liberalization period. The foremost among the challenges faced by the banking sector today is the challenge of understanding and managing the risk. The very nature of the banking business is having the threat of risk imbibed in it. Banks' main role is intermediation between those having resources and those requiring resources. Thus, in this paper, “ MANAGEMENT OF LIQUIDITY RISK IN THE INDIAN BANKING SECTOR- A CASE STUDY OF UCOBANK”, the purpose is to find the liquidity management, the NPA status and the capital adequacy. For this various ratios has been used and statistical tool Chi Square has been used for the testing of hypothesis. The study is limited to the information and financial data of UCO Bank, collected from secondary sources.

Keywords: *Liquidity, Non performing Assets, Capital Adequacy.*

Introduction

In view of growing complexity of banks' business and the dynamic operating environment, risk management has become very significant, especially in the financial sector. Risk at the apex level may be visualized as the probability of a banks' financial health being impaired due to one or more contingent factors. While the parameters indicating the banks' health may vary from net interest margin to market value of equity, the factor which can cause the important are also numerous.

The past decade has seen dramatic losses in the banking industry. Firms that had been performing well suddenly announced large losses due to credit exposures that turned sour, interest rate positions taken, or derivative exposures that may or may not have been assumed to hedge balance sheet risk. In response to this, commercial banks have almost universally embarked upon an upgrading of their risk management and control systems.

Purpose of the Study

today's, risk management is a critical issue for the financial institution particularly in banking sector. The business of banking and finance has changed dramatically especially in the last decade in the face of deregulation, rapid advances in information and communications technology, and constant innovation in financial technology. Risk Management has got much importance in the Indian Economy during this liberalization period. The foremost among the challenges faced by the banking sector today is the challenge of understanding and managing the risk. The very nature of the banking business is having the threat of risk imbibed in it. Banks' main role is intermediation between those having resources and those requiring resources. Therefore, the overall purpose of the research is to analyse the “ MANAGEMENT OF LIQUIDITY RISK IN THE INDIAN BANKINGSECTOR- A CASE STUDY OF UCO BANK”.

Objectives of the study

Objectives of this research are verifying the integrity of liquidity risk management systems in the banking sector.

Beside the general purpose of the research, the following specific objectives have been mentioned in the research:

- discuss the concept of liquidity risk management
- analyse the current ratio, capital adequacy ratio, and NPA ratio

Testing of hypothesis

The study aims at examining the following hypothesis with available data and techniques. The hypotheses are: -

- Capital adequacy ratio is above the minimum requirements
- Bank maintains a standard NPA.
- Banks maintain quality securities with good liquidity to meet contingencies

Research methodology

Data Source

The study relied mainly on secondary data, i.e. from various online websites. PLAN OF ANALYSIS:

The data analysis of the information got from the balance sheets was done and ratios were used. Graph and charts were used to illustrate trends.



Period

The period of this paper is for 2 days.

Tools of the Study

There are many method for investigation of liquidity risk management in this research we used statistical analysis. For data analysis we used rating method for calculating of risk and various liquidity ratios and statistic method Chi Square test for testing hypotheses.

This paper involves the analyses :CAPITAL ADEQUACY, NPA AND LIQUIDITY

Analysis.

Concept of liquidity risk management

Risk management

Risk Management is the application of proactive strategy to plan, lead, organize, and control the wide variety of risks that are woven into the fabric of an organization's daily and long-term functioning. Like it or not, risk has a say in the achievement of our goals and in the overall success of an organization.

Liquidity risk

Liquidity risk is the potential for 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.

The risk that arises from the difficulty of selling an asset. An investment may sometimes need to be sold quickly. Unfortunately, an insufficient secondary market may prevent the liquidation or limit the funds that can be generated from the asset.

Liquidity risk can best be described as the risk of a funding crisis. While some would include the need to plan for growth and unexpected expansion of credit, the risk here is seen more correctly as the potential for a funding crisis. Such a situation would inevitably be associated with an unexpected event, such as a large charge off, loss of confidence, or a crisis of national proportion such as a currency crisis.

Liquidity risk consists of Funding Risk, Time Risk & Call Risk.

Funding Risk: It is the need to replace net out flows due to unanticipated withdrawal/nonrenewal of deposit.

Time risk: It is the need to compensate for non receipt of expected inflows of funds, i.e. performing assets turning into nonperforming assets.

Call risk: It happens on account of crystallisation of contingent liabilities and inability to undertake profitable business opportunities when desired.

Liquidity Risk Management

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. One of the cornerstones of our liquidity risk management framework is to maintain a comfortable liquidity position, meaning the ability to meet our financial obligations even if we have difficulties in raising any new funding over a longer period.

The indian banking industry and concept of liquidity risk management

The Indian banking industry, the backbone of the economy, has gained immense recognition for its strength, particularly in the wake of the global financial crisis, which pushed its global counterparts to the brink of collapse. The Indian banking industry played a key role in averting the financial crisis from reaching disastrous proportions in the country.

UCO Bank

UCO Bank, previously known as United Commercial Bank, is a leading commercial bank in India. Founded in Kolkata in 1943, UCO Bank is one of the oldest Indian banks as well. It was the eminent Indian industrialist Ghanshyam Das Birla who,

during the Quit India Movement of 1942, thought of establishing a commercial bank with Indian capital and management. United Commercial Bank was the outcome of that idea. It, along with 13 others, was nationalized on July 19, 1969. In the year 1985, its name was changed to UCO Bank. Currently, UCO Bank has around 2000 Service Unites spread all across the nation. It also has two overseas branches in Hong Kong and Singapore.

The banking industry has long viewed the problem of risk management as the need to control four of the above risks which make up most, if not all, of their risk exposure, viz., credit, interest rate, foreign exchange and liquidity risk. While they recognize counterparty and legal risks, they view them as less central to their concerns. Where counterparty risk is significant,

it is evaluated using standard credit risk procedures, and often within the credit department itself. Likewise, most bankers would view legal risks as arising from their credit decisions or, more likely, proper process not employed in financial contracting.

Capital adequacy

Capital adequacy ratio is defined as

$$= \frac{\text{Risk Weighted Assets}}{\text{Minimum Total Capital Requirement}}$$

, Where Risk can either be weighted assets or the respective national regulator's minimum total capital requirement. If using risk weighted assets,

$$= \frac{\text{Risk Weighted Assets}}{\text{Minimum Total Capital Requirement}} \times 100 \geq 8\%$$

The percent threshold (8% in this case, a common requirement for regulators conforming to the Basel Accords) is set by the national banking regulator.

CAPITAL ADEQUACY RATIO:					
TABLE					
YEAR	MAR'09	MAR'10	MAR'11	MAR'12	MAR'13
CAPITALADEQUAC	11.12	11.56	10.09	11.93	13.21
Y					
GRAPH					

Interpretation

Capital adequacy ratio (CAR) is a ratio of a bank's capital to its risk.

National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and are complying with their statutory Capital requirements.

The formula for Capital Adequacy Ratio is, (Tier 1 Capital + Tier 2 Capital)/Risk Weighted Assets.

Capital adequacy ratio is the ratio which determines the capacity of the bank in terms of meeting the time liabilities and other risks such as credit risk, operational risk, etc. In the simplest formulation, a bank's capital is the "cushion" for potential losses, which protects the bank's depositors or other lenders.

Here, incase of UCO Bank we can see that its CAR showed a sudden dip in the year 2011 but after that it has shown a steady

rise for the next 2 years which is a good sign for its depositors and investors.

GROSS NPA TO NET ADVANCES- TABLE 5.3.1(in %)

2011	1652/51129	0.0323
2012	1540/64020	0.024
2013	1640/77560	0.021

Interpretation

The gross NPA was 1652, 1540 and 1640 in 2011, 12 and 2013 respectively. The analysis shows that the gross nonperforming assets were 3.2% Of the net advances means the bank was not able to receive the repayment of 3.2% of the total loan and advances.

In 2012 it was 2.4% of the total net advances means that the bank is improving its capability to get return its loans and advances in comparison to 2011 that is it was lesser than the gross NPA of 2011.Same in the 2013 it was continue decreasing

Overall interpretation is the UCO bank is focusing towards the NPA the company doesn't want to increase the NPA because it will affect the performance of the bank as due to increase in NPA the capital adequacy, of the bank will decrease.

Current Ratio

YEAR	MAR'09	MAR'10	MAR'11	MAR'12	MAR'13
CURRENT RATIO	0.3	0.31	0.35	0.72	0.7

Current Ratio may be defined as the relationship between current assets and current liabilities and used to make the analysis of a short term financial position. A relatively high current ratio is an indication that the firm is liquid and has the ability to pay its current obligations in time. The factors taken into consideration are the type of business, type of products, reputation of the concern, seasonal influence and types of assets available. Here Current ratio trend has increased tremendously from 2011 to 2012 but has decreased from 2012 to 2013.

Hypothesis 1: The capital adequacy ratio is above minimum requirements Chi- Square test will be used to determine if there is any difference between the bank's capital adequacy ratio and the one required by the Basel accords.

H0: Null Hypothesis: There is no significant difference between the bank's capital adequacy ratio and the statutory required ratio.

H1: Alternative hypothesis: There is a significant difference between the bank's capital adequacy ratio and the statutory ratio.

Observed	Statutory		
Capital	Capital		
adequacy	adequacy		
Ratio	ratio		
O	E	(O-E) ²	(O-E) ² /E
11.12	8	9.73	1.22
11.56	8	12.67	1.58
10.09	8	4.37	0.54
11.93	8	15.44	1.93
13.21	8	27.14	3.39
			8.66

$$h = \frac{(O-E)^2}{E} = 8.66$$

The table value for chi-square is 3.84. Since the calculated value is above the table value, H1 is rejected, and this means that there is a significant difference between the bank's ratio and the statutory ratio. This proves that the bank's capital adequacy ratio is above the minimum requirements.

Hypothesis 2: The bank maintains a standard NPA ratio

The bank's NPA ratio will be compared with the average NPA ratio in the banking industry to test for significance of differences, using Chi-square test.

H0: Null hypothesis: There is no significant difference between the bank's NPA ratio and the standard NPA ratio

H1: Alternative hypothesis: There is a significant difference between the bank's NPA ratio and the standard NPA ratio.

UCO	Standard		
Bank's	NPA ratio		
NPA			
ratio			
O	E	(O-E) ²	(O-E) ² /E
3.23	2	1.5	0.75
2.4	2	0.16	0.08
2.1	2	0.01	0.005
2	2	1	0.5
			1.335

The table value for chi-square is 3.84. Since the calculated value is less than the table value,

H0 is accepted, this means that there is no significant difference between the bank's NPA ratio and the Standard NPA ratio. This proves that the bank maintains a standard NPA ratio.

Hypothesis 3: Banks maintain quality securities with good liquidity to meet contingencies

To ensure liquidity amongst banks, the RBI requires a capital adequacy ratio of 10%. To test this hypothesis, this ratio will be compared with the one of UCO Bank to find out how safe banks are in India.

H0: There is no significant difference between the capital adequacy ratio of UCO Bank and the one required by the RBI.

H1: There is a significant difference between the capital adequacy ratio of UCO bank and the one required by the RBI.

UCO	Capital		
capital	adequacy		
adequacy	requirement		
ratio	for private		
	sector Banks		
O	E	(O-E) ²	(O-E) ² /E
11.12	10	1.25	0.125
11.56	10	2.43	0.243
10.09	10	0.0081	0.00081
11.93	10	3.72	0.372
13.21	10	1.03	1.03
			1.77081



The table value for chi-square is 3.84. Since the calculated value is below the table value, H1 is accepted, meaning that there is no significant difference between the two ratios. Therefore, banks have good liquidity for meeting contingencies.

Findings

- Capital adequacy: The capital adequacy ratio of the bank is above the minimum requirements and above the industry average.
- Assets: UCO Bank has maintained a standard for the NPA's in the period of 2011-2013. UCO bank has shown remarkable decrease in NPA's in the same period.
- Management: Professional approach that has been adopted by the banks in the recent past is in right direction & also it is the right decision.
- Liquidity: Banks should maintain quality securities with good liquidity to meet contingencies.

Recommendations

- UCO banks should adapt themselves quickly to the changing norms.
- The system is getting internationally standardized with the coming of BASELL II accords so the UCO bank and Indian banks should strengthen internal processes so as to cope with the standards.
- UCO bank should maintain a 0% NPA by always lending and investing or creating quality assets which earn returns by way of interest and profits.
- UCO bank should find more avenues to hedge risks as the market is very sensitive to risk of any type.
- Have good appraisal skills, system, and proper follow up to ensure that UCO bank is above the risk.

Conclusion

The banking industry is clearly evolving to a higher level of risk management techniques and approaches than had been in place in the past. Yet, as this review indicates, there is significant room for improvement. The risk management approaches used here are taken at smaller institutions, as well as larger but relatively less sophisticated ones, are less precise and significantly less analytic.