Risk Management in Banks

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Abstract

In the modern business life, since the transactions have become very fast and their risk exposure increases, the companies, especially the financial institutions, started to use new techniques to measure the probable effects of the risks that they have taken while undertaking the transactions. Risk Management is the application of proactive strategy to plan, lead, organize, and control the wide variety of risks that are rushed into the fabric of an organization's daily and long-term functioning. The present paper is to make an attempt to identify the risks faced by the banks. This paper also examined the different techniques adopted by banks and role of RBI for risk management. To achieve the objectives of the study data has been collected from secondary sources i.e., from Books, journals and online publications. Finally it can be concluded that the banks should take risk more consciously, anticipates adverse changes and hedges accordingly, it becomes a source of competitive advantage, and efficient management of the banking industry.

KEYWORDS: Risk Management, Banking Sector, RBI, Credit risk, Market risk.

I. Introduction

Risk is defined as anything that can create hindrances in the way of achievement of certain objectives. It can be because of either internal factors or external factors, depending upon the type of risk that exists within a particular situation. Exposure to that risk can make a situation more critical. A better way to deal with such a situation; is to take certain proactive measures to identify any kind of risk that can result in undesirable outcomes. In simple terms, it can be said that managing a risk in advance is far better than waiting for its occurrence. Risk Management is a measure that is used for identifying, analyzing and then responding to a particular risk. It is a process that is continuous in nature and a helpful tool in decision making process.

According to the Higher Education Funding Council for England (HEFCE), Risk Management is not just used for ensuring the reduction of the probability of bad happenings but it also covers the increase in likeliness of occurring good things. A model called "Prospect Theory" states that a person is more likely to take on the risk than to suffer a sure loss.

II. Purpose Of The Research

Risk Analysis and 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. So, regarding to international banking rule (Basel Committee Accords) and RBI guidelines the investigation of risk analysis and risk management in banking sector is being most important.

III. Objectives The Study

The following are the objectives of the study.

i. To identify the risks faced by the banking industry.
ii. To examine the techniques adopted by banking industry for risk management.

IV. Research Methodology

This paper is theoretical modal based on the extensive research for which the secondary source of information has gathered. The sources include online publications, Books and journals.

V. Types Of Risks In Banking Sector

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. There are few list of various types of risk:

1. Liquidity Risk

The liquidity risk of banks arises from funding of long-term assets by short-term liabilities, thereby making the liabilities subject to rollover or refinancing risk. The liquidity risk in banks manifest in different dimensions –

(a) Funding Risk: Funding Liquidity Risk is defined as the inability to obtain funds to meet cash flow obligations. For banks, funding liquidity risk is crucial. This arises from the need to replace net outflows due to unanticipated withdrawal/ non-renewal of deposits (wholesale and retail).
(b) Time Risk: Time risk arises from the need to compensate for non-receipt of expected inflows of funds i.e., performing assets turning into non-performing assets.
(c) Call Risk: Call risk arises due to crystallization of contingent liabilities. It may also arise when a bank may not be able to undertake profitable business opportunities when it arises.

2. Interest Rate Risk

Interest Rate Risk arises when the **Net Interest Margin or the Market Value of Equity (MVE)** of an institution is affected due to changes in the interest rates.
Internal Rate of Return (IRR) can be viewed in two ways – its impact is on the earnings of the bank and its impact on the economic value of the bank's assets, liabilities and Off-Balance Sheet (OBS) positions. Interest rate Risk can take different forms.

3. **Market Risk**

The risk of adverse deviations of the market-to-market value of the trading portfolio, due to market movements, during the period required to liquidate the transactions is termed as Market Risk. This risk results from adverse movements in the level or volatility of the market prices of interest rate instruments, equities, commodities, and currencies. It is also referred to as Price Risk.

(a) **Forex Risk:** Forex risk is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position either spot or forward, or a combination of the two, in an individual foreign currency.
(b) **Market Liquidity Risk:** Market liquidity risk arises when a bank is unable to conclude a large transaction in a particular instrument near the current market price.

4. **Default or Credit Risk**

Credit risk is more simply defined as the potential of a bank borrower or counterparty to fail to meet its obligations in accordance with the agreed terms. For most banks, **loans are the largest and most obvious source of credit risk**. It is the most significant risk, more so in the Indian scenario where the NPA level of the banking system is significantly high.
(a) Counterparty Risk: This is a variant of Credit risk and is related to non-performance of the trading partners due to counterparty's refusal and or inability to perform. The counterparty risk is generally viewed as a transient financial risk associated with trading rather than standard credit risk.
(b) Country Risk: This is also a type of credit risk where non-performance of a borrower or counterparty arises due to constraints or restrictions imposed by a country. Here, the reason of non-performance is external factors on which the borrower or the counterparty has no control.

5. **Operational Risk**

Basel Committee for Banking Supervision has defined operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'. Two of the most common operational risks are discussed below –

(a) Transaction Risk: Transaction risk is the risk arising from fraud, both internal and external, failed business processes and the inability to maintain business continuity and manage information.
(b) Compliance Risk: Compliance risk is the risk of legal or regulatory sanction, financial loss or reputation loss that a bank may suffer as a result of its failure to comply with any or all of the applicable laws, regulations, codes of conduct and standards of good practice. It is also called integrity risk since a bank's reputation is closely linked to its adherence to principles of integrity and fair dealing.

6. **Other Risks**

Apart from the above-mentioned risks, following are the other risks confronted by Banks in course of their business operations –

(a) Strategic Risk: Strategic Risk is the risk arising from adverse business decisions, improper implementation of decisions or lack of responsiveness to industry changes.

(b) Reputation Risk: Reputation Risk is the risk arising from negative public opinion. This risk may expose the institution to litigation, financial loss or decline in customer base.

VI. Techniques Of Risk Management

The following are the techniques:

a) GAP Analysis

It is an interest rate risk management tool based on the balance sheet which focuses on the potential variability of net-interest income over specific time intervals. In this method a maturity/ re-pricing schedule that distributes interest-sensitive assets, liabilities, and off-balance sheet positions into time bands according to their maturity (if fixed rate) or time remaining to their next re-pricing (if floating rate), is prepared. These schedules are then used to generate indicators of interest-rate sensitivity of both earnings and economic value to changing interest rates. After choosing the time intervals, assets and liabilities are grouped into these time buckets according to maturity (for fixed rates) or first possible re-pricing time (for flexible rate s). The assets and liabilities that can be re-priced are called rate sensitive assets (RSAs) and rate sensitive liabilities (RSLs) respectively. Interest sensitive gap (DGAP) reflects the differences between the volume of rate sensitive asset and the volume of rate sensitive liability and given by, GAP = RSAs – RSLs The information on GAP gives the management an idea about the effects on net-income due to changes in the interest rate. Positive GAP indicates that an increase in future interest rate would increase the net interest income as the change in interest income is greater than the change in interest expenses and vice versa.

b) Risk Adjusted Rate of Return on Capital (RAROC)

It gives an economic basis to measure all the relevant risks consistently and gives managers tools to make the efficient decisions regarding risk/return tradeoff in different assets. As economic capital protects financial institutions against unexpected losses, it is vital to allocate capital for various risks that these institutions face. Risk Adjusted Rate of Return on Capital (RAROC) analysis shows how much economic capital different products and businesses need and determines the total return on capital of a firm. Though Risk Adjusted Rate of Return can be used to estimate the capital requirements for market, credit and operational risks, it is used as an integrated risk management tool (Crouhy and Robert, 2001)

c) Securitization

It is a procedure studied under the systems of structured finance or credit linked notes. Securitization of a banks assets and loans is a device for raising new funds and reducing banks risk exposures. The bank pools a group of income-earning assets (like mortgages) and sells securities against these in the open market, thereby transforming illiquid assets into tradable asset backed securities. As the returns from these securities depend on the cash flows of the underlying assets, the burden of repayment is transferred from the originator to these pooled assets.

d) Sensitivity Analysis

It is very useful when attempting to determine the impact, the actual outcome of a particular variable will have if it differs from what was previously assumed. By creating a given set of scenarios, the analyst can determine how changes in one variable(s) will impact the target variable.

e) Internal Rating System

An internal rating system helps financial institutions manage and control credit risks they face through lending and other operations by grouping and managing the credit-worthiness of borrowers and the quality of credit transactions.

VII. Role Of RBI In Risk Management In Banks

RBI used some tools for management of risk and to evaluate the financial soundness of the Banks. This tool is known as "CAMELS". CAMELS is the collective tool of six components namely:

- Capital Adequacy
- Asset Quality
- Management
- Earnings Quality
- Liquidity
- Sensitivity to Market risk

The CAMEL was recommended for the financial soundness of bank in 1988 while the sixth component called sensitivity to market risk (S) was added to CAMEL in 1997.

VIII. Conclusion

The following are the conclusions of the study.

- Risk management underscores the fact that the survival of an organization depends heavily on its capabilities to anticipate and prepare for the change rather than just waiting for the change and react to it.
- The objective of risk management is not to prohibit or prevent risk taking activity, but to ensure that the risks are consciously taken with full knowledge, clear purpose and understanding so that it can be measured and mitigated.
- Risk Management Committee, Credit Policy Committee, Asset Liability Committee, etc are such committees that handle the risk management aspects.
- Functions of risk management should actually be bank specific dictated by the size and quality of balance sheet, complexity of functions, technical/ professional manpower and the status of MIS in place in that bank.
- Regarding use of risk management techniques, it is found that internal rating system and risk adjusted rate of return on capital are important.
- The effectiveness of risk measurement in banks depends on efficient Management Information System, computerization and net working of the branch activities.

- The banks can take risk more consciously, anticipates adverse changes and hedges accordingly; it becomes a source of competitive advantage, as it can offer its products at a better price than its competitors.

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