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RISK MANAGEMENT IN BANKS

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Abstract

Risk analysis and risk management has achieved great importance in the post liberalization period. The fundamental challenges faced by the banking industry is the challenge of understanding and managing the risks. Banking is such a business of its kind, which has that aspect of risk already imbibed in it. Banks have always been playing the role of intermediation- those having resources and those ready to acquire resources. Thus, to measure the risk at a higher level, various risks like credit risks, market risks and operational risks should be combined and a single factor has to be treated which can be worked out. Hence with regards to Basel committee norms and RBI guidelines, investigation of risk analysis and risk management in banking sector is of utmost importance.

Keywords: *Risk, Banking, Management of Risk*

Introduction

Risk is the fundamental element that drives financial behavior. Without risk, the entire financial industry would have been completely simple. However, risk is omnipresent in the world. The various financial institutions should manage their risk effectively to survive. The future of banking industry undoubtedly relies on risk management dynamics. The banks which have efficient risk management systems will only survive in the long run. The effective management of risks is essentially important for long term success of banking institution. Risk management is actually the application of proactive strategy to plan, lead and control the wide

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variety of risks that are into the functioning of an organization. Risk has an important say in the achievement of the goals and the overall success of an organization. It can be due to internal and external factors depending on the type of risk that exists in a particular situation. Exposure to these types of risks can sometimes make the situation more critical. Hence, its always said that managing the risk in advance is far better than waiting for its occurrence.

Risk Management Process

To overcome the risk and to make banking function well, there is a need to manage all kinds of risks associated with the banking. Risk management becomes one of the main functions of any banking services risk management consists of identifying the risk and controlling them, means keeping the risk at acceptable level. These levels differ from institution to institution and country to country. The basic objective of risk management is to stakeholders; value by maximizing the profit and optimizing the capital funds for ensuring long term solvency of the banking organization. In the process of risk management following functions comprises:

- **Risk Origination within the bank**

This is the basic step of the risk management process. It helps us to identify the source of the risk and then work accordingly. Since, there are many types of risks associated with the banks, it becomes necessary to determine the origin.

- **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. In other words, credit risk can be defined as the risk that the interest or principal or both will not be paid as promised and is estimated by observing the proportion of assets that are below standard. Credit risk is borne by all lenders and will lead to serious problems, if excessive. 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. The Asian Financial crisis, which emerged due to rise in NPAs to over 30% of the total assets of the financial system of various countries, highlights the importance of management of credit risk

- **Market Risk**

The risk of adverse deviations of the mark-to-market value of the trading portfolio, due to market movements, during the period required to liquidate the transactions is termed as Market

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Risk (Kumar et al., 2005). 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. 87 Price risk occurs when assets are sold before their stated maturities. In the financial market, bond prices and yields are inversely related. The price risk is closely associated with the trading book, which is created for making profit out of short-term movements in interest rates. The term Market risk applies to :

(i) That part of IRR which affects the price of interest rate instruments

(ii) Pricing risk for all other assets/ portfolio that are held in the trading book of the bank .

(iii) Foreign Currency Risk.

- **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'. Thus, operational loss has mainly three exposure classes namely people, processes and systems. Managing operational risk has become important for banks due to the following reasons:

1. Higher level of automation in rendering banking and financial services
2. Increase in global financial inter-linkages

- **Risk Identification**

After understanding the origin of risk in the bank, it then becomes necessary to identify, understand and analyze risks. These risks need to be analyzed and worked on to get the desired results.

- **Identify risks**

The risk needs to be identified and properly worked upon. The risk identification plays an important role so as to control that particular factor.

- **Understand and Analyze risks**

After identifying the risks associated with each department, one needs to understand and analyze the same for proper functioning and execution. Understanding and analyzing the risks helps us to work towards the assessment and measurement of the risks.

- **Risk Assessment and Measurement**

This step helps to determine the weightage of the risks we have figured out. It helps to identify

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what should be done to the above risks and how they should be treated then.

- **Assess the risk impact**

The view is that risk measuring is required to exercise control and to make fact-based and defensible decisions. A disclosure of levels of risk would also be beneficial to investors/creditors. Measuring risk is the cornerstone of Basel II , the regulatory regime of the international banking system, resting on a deeply rooted belief in society that risk can be measured, controlled and managed. Numbers allow complex and abstract conditions to be summarized in a way that is easy to understand. Few people challenge the use of numbers, most people find figures reliable and if the majority of influential individuals are convinces that a numerical approach is superior to any other this approach will be uncritically accepted. It seems to be a general unwillingness in society to talk about risk as a product that is constructed, controlled and consumed by networks of people. The assumption is instead that it is possible to capture all relevant facts and circumstances through measurement technologies. The general perception is that numbers deliver the truth and, consequently, they provide a sense of security. However, it may be claimed risk modeling is based on a fundamental misunderstanding of the properties of risk. It may be claimed quantification of risk has no justification. Under stable conditions, measured risk is regarded as manageable and controllable. If risk is synonymous with chaos, the risk is an unpredictable and random phenomenon. Under dramatically different circumstances, statistically derived information on historical information cannot be used since such information is derived from models that are unable to adequately capture extremes in values during crisis. Since these risks often arise unexpectedly they are difficult to control. Statistical models may fail since the data produced during crisis are often radically different from data generated during periods of stability. Risk management tools are insufficient for anticipating risk during troubled times.

- **Measure the risk impact**

In the statistically deductive use of risk the assumptions are never discussed. And it is the threat to the assumptions that indicate the real risk! Yet due to unquestioned assumptions, some bank managers do not recognize the risk they are exposed to. Information provided by the risk measurement tools gets a fact-like status. This may cause an over-reliance on models and statistics – an over reliance that is a new form of risk. Managers may work under the illusion

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of safety, believing situations are under control. There is a need to search for an alternative paradigm since risk can only ever be imperfectly understood if reliance is placed exclusively on the classical conception. The assumptions underlying risk measurement procedures may be challenged. Discussions where quantitative as well as qualitative aspects are evaluated in decision making are essential for assessing risk. In short we argue in favor of risk assessment and against risk measurement. Thus it is essential to understand how bank managers perceive risk and how they assess risk. Not much is known today about bank managers' perceptions of risk. A number of researchers have called for empirically based studies on perceptions on risk in practice. We need to examine this by looking at practice and by asking users how bank managers perceive risk. We should ask what behavioral implications are associated with risk as a result of the Basel regulations.

- **Risk Control**
- **Avoidance**

Avoidance is the best means of loss control. This is because, as the name implies, you're avoiding the risk completely. If your efforts at avoiding the loss have been successful, then there is a 0% probability that you'll suffer a loss (from that particular risk factor, anyway). This is why avoidance is generally the first of the risk control techniques that's considered. It's a means of completely eliminating a threat.

- **Loss Prevention**

Loss prevention is a technique that limits, rather than eliminates, loss. Instead of avoiding a risk completely, this technique accepts a risk but attempts to minimize the loss as a result of it. For example, storing inventory in a warehouse means that it is susceptible to theft. However, since there really is no way to avoid it, a loss prevention program is put in place to minimize the loss. This program can include patrolling security guards, video cameras, and secured storage facilities.

- **Loss Reduction**

Loss reduction is a technique that not only accepts risk, but accepts the fact that loss might occur as a result of the risk. This technique will seek to minimize the loss in the event of some type of threat. For example, a company might need to store flammable material in a warehouse. Company management realizes that this is a necessary risk and decides to install state-of-the-

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art water sprinklers in the warehouse. If a fire occurs, the amount of loss will be minimized.

- **Separation**

Separation is a risk control technique that involves dispersing key assets. This ensures that if something catastrophic occurs at one location, the impact to the business is limited to the assets only at that location. On the other hand, if all assets were at that location, then the business would face a much more serious challenge. An example of this is when a company utilizes a geographically diversified workforce.

- **Duplication**

Duplication is a risk control technique that essentially involves the creation of a backup plan. This is often necessary with technology. A failure with an information systems server shouldn't bring the whole business to a halt. Instead, a backup or fail-over server should be readily available for access in the event that the primary server fails. Another example of duplication as a risk control technique is when a company makes use of a disaster recovery service.

- **Diversification**

Diversification is a risk control technique that allocates business resources to create multiple lines of business that offer a variety of products and/or services in different industries. With diversification, a significant revenue loss from one line of business will not cause irreparable harm to the company's bottom line. Risk control is a key component in any sound company strategy. It's necessary to ensure long-term organization sustainability and profitability

- **Risk Monitoring**

An effective measurement and monitoring process is essential for adequately managing liquidity risk. At a very basic level, liquidity measurement involves assessing all of an institution's cash inflows against its outflows to identify the potential for any net shortfalls going forward. This includes funding requirements for off-balance sheet commitments. A number of techniques can be used for measuring liquidity risk, ranging from simple calculations and static simulations based on current holdings to highly sophisticated modeling techniques. As all institutions are affected by changes in the economic climate and market conditions, the monitoring of economic and market trends is key to liquidity risk management. An important aspect of managing liquidity is making assumptions about future funding needs. While certain cash inflows and outflows can be easily calculated or predicted, institutions must

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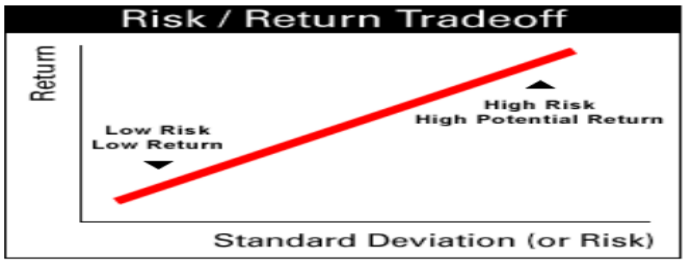
also make assumptions about future liquidity needs, both in the very short-term and for longer time periods. One important factor to consider is the critical role an institution's reputation plays in its ability to access funds readily and at reasonable terms. For that reason, staff responsible for managing overall liquidity should be aware of any information public or otherwise, that could have an impact on market and public perceptions about the soundness of the institution.

- **Risk Return Trade-off**

Deciding what amount of risk you can take while remaining comfortable with your investments is very important. In the investing world, the dictionary definition of risk is the chance that an investment's actual return will be different than expected. Technically, this is measured in statistics by standard deviation. Practically, risk means you have the possibility of losing some or even all of your original investment. Low risks are associated with low potential returns. High risks are associated with high potential returns. The risk return trade-off is an effort to achieve a balance between the desire for the lowest possible risk and the highest possible return. The risk return trade-off theory is aptly demonstrated graphically in the chart below. A higher standard deviation means a higher risk and therefore a higher possible return. A common misconception is that higher risk equals greater return. The risk return trade-off tells us that the higher risk gives us the possibility of higher returns. There are no guarantees. Just as risk means higher potential returns, it also means higher potential losses. On the lower end of the risk scale is a measure called the risk-free rate of return. It is represented by the return on 10 year Government of India Securities because their chance of default (i.e. not being able to repay principal and interest) is next to nothing. This risk free rate is used as a reference for equity markets whereas the overnight repo rate is used as a reference for debt markets. If the risk-free rate is currently 6 per cent, this means, with virtually no risk, we can earn 6 per cent per year on our money.



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Conclusions

As risk is indispensable for banking business, proper assessment of risk is an integral part of a bank's risk management system. Banks are focusing on the magnitude of their risk exposure and formulating strategies to tackle those effectively. In the context of risk management practices, the introduction of Basel II norms and its subsequent adoption by RBI is a significant measure that promises to promote sound risk management practices. BASEL II seeks to enhance the risk sensitivity of capital requirements, promote a comprehensive coverage of risks, offer a more flexible approach through a menu of options, and is intended to be applied to banks worldwide. Moreover, the RBI has adopted a series of steps to ensure that individual banks tackle risks effectively by setting up risk management cells and also through internal assessment of their risk exposure. Apart from this, RBI has opted for on-site and off-site surveillance methods for effective risk management in the Indian Banking sector, so that systemic risk and financial turmoil can be averted in the country.

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