Risk Management in Banking Sector - An Empirical Study

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Abstract: Risk Management is the application of proactive strategy to plan, lead, organize, and control different types of risks which are faced by a business organization. Present paper is to make an attempt to identify the risks faced by the banking sectors and the process of risk management. This paper also examined the different techniques adopted by banking industry for risk management. In times of volatility and fluctuations in the market, financial institutions need to prove their mettle by withstanding the market variations and achieve sustainability in terms of growth and well as have a stable share value. Hence, an essential component of risk management framework would be to mitigate all the risks and rewards of the products and service offered by the bank. Thus the need for an efficient risk management framework is paramount in order to factor in internal and external risks.

KEYWORDS: Risk Management, Banking Sector, Credit risk, Market variations, sustainability.

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. 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.

OBJECTIVES OF THE STUDY: 1) To identify the risks faced by the banking industry. 2) To trace out the process of risk management. 3)To examine the techniques adopted by banking industry for risk management.

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 and websites.

TYPES OF RISKS IN BANKING SECTOR: Following are the different types of risks in Banking Industry

Credit Risk: The Basel Committee on Banking Supervision defines credit risk as the potential that a bank borrower, or counterparty, will fail to meet its payment obligations regarding the terms agreed with the bank. It includes both uncertainty involved in repayment of the bank’s dues and repayment of dues on time.

Market Risk: Market Risk may be defined as the possibility of loss to bank caused by the changes in the market variables. It is the risk that the value of on-/off-balance sheet positions will be adversely affected by movements in equity and interest rate markets, currency exchange rates and commodity prices. Market risk is the risk to the bank’s earnings and capital due to changes in the market level of interest rates or prices of securities, foreign exchange and equities, as well as the volatilities of those prices. The following are types of market risks:

Liquidity Risk: Bank Deposits generally have a much shorter contractual maturity than loans and liquidity management needs to provide a cushion to cover anticipated deposit withdrawals. Liquidity is the ability to efficiently accommodate deposit as also reduction in liabilities and to fund the loan growth and possible funding of the off-balance sheet claims. The cash flows are placed in different time buckets based on future likely behavior of assets, liabilities and off-balance sheet items. Liquidity risk consists of Funding Risk, Time Risk & Call Risk.

Interest Rate Risk: Interest Rate Risk is the potential negative impact on the Net Interest
Income and it refers to the vulnerability of an institution’s financial condition to the movement in interest rates. Changes in interest rate affect earnings, value of assets, liability off-balance sheet items and cash flow. Earnings perspective involves analyzing the impact of changes in interest rates on accrual or reported earnings in the near term. This is measured by measuring the changes in the Net Interest Income (NII) equivalent to the difference between total interest income and total interest expense.

OPERATIONAL RISK: The Basel Committee on Banking Supervision (or BCBS) defines credit risk as the potential that a bank borrower, or counter party, will fail to meet its payment obligations regarding the terms agreed with the bank. It includes both uncertainty involved in repayment of the bank’s dues and repayment of dues on time.

Causes of operational risks
There are many causes of operational risks. It’s difficult to prepare an exhaustive list of causes because operational risks may occur from unknown and unexpected sources. Broadly, most operational risks arise from one of three sources.

1. People risk: Incompetency or wrong posting of personnel and misuse of powers
2. Information technology risk: The failure of the information technology system, the hacking of the computer network by outsiders, and the programming errors that can take place any time and can cause loss to the bank
3. Process-related risks: Possibilities of errors in information processing, data transmission, data retrieval, and inaccuracy of result or output

Liquidity Risk: Liquidity means a bank has the ability to meet payment obligations primarily from its depositors and has enough money to give loans. So liquidity risk is the risk of a bank not being able to have enough cash to carry out its day-to-day operations. Provision for adequate liquidity in a bank is crucial because a liquidity shortfall in meeting commitments to other banks and financial institutions can have serious repercussions on the bank’s reputation and the bank’s bond prices in the money market.

Reputational Risk: Reputational risk is the risk of damage to a bank’s image and public standing that occurs due to some dubious actions taken by the bank. Sometimes reputational risk can be due to perception or negative publicity against the bank and without any solid evidence of wrongdoing. Reputational risk leads to the public’s loss of confidence in a bank.

Business Risk: Business risk is the risk arising from a bank’s long-term business strategy. It deals with a bank not being able to keep up with changing competition dynamics, losing market share over time, and being closed or acquired. Business risk can also arise from a bank choosing the wrong strategy, which might lead to its failure.

Other Risks: There are some other minor types of risks that a bank carries. These aren’t as important as the previous risks discussed, but we’ll mention them in this article.

Legal Risk: A bank can be exposed to legal risk. Legal risk can be in the form of financial loss arising from legal suits filed against the bank or by a bank for applying a law wrongly.

Country Risk: A bank that operates in many countries also faces country risk when there’s a localized economic problem in a certain country. In such a scenario, the bank’s holding company may need to bear losses in case it exceeds the capital of a subsidiary in the country. The holding company in certain cases may also need to provide capital.

Process of risk management:

Step 1: Risk Identification - Identify Risks Understand and Analyze Risks

Step 2: Risk Assessment and Measurement - Assess the Risk Impact Measure the Risk Impact

Step 3: Risk Control - Recommendations for Risk Control Risk Mitigation through Control Techniques Deputation of Competent Officers to Deal with the Risks

Step 4: Risk Monitoring - Supervise the Risks Reporting on Progress Compliance with Regulations Follow-up.

Step 5: Risk-Return Trade-Off -Balancing of Risk against Return.

TECHNIQUES OF RISK MANAGEMENT:

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 rates). 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. (Cumming and Beverly, 2001)

**Value at Risk (VaR)**: It is one of the newer risk management tools. The Value at Risk (VaR) indicates how much a firm can lose or make with a certain probability in a given time horizon. VaR summarizes financial risk inherent in portfolios into a simple number. Though VaR is used to measure market risk in general, it incorporates many other risks like foreign currency, commodities, and equities. (Jorion, 2001)

**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.

**Securitization**: It is a procedure studied under the systems of structured finance or credit linked notes. Securitization of a bank’s assets and loans is a device for raising new funds and reducing bank’s 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.

**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.

**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.

**CONCLUSIONS**: The following are the conclusions drawn from the study.

1. 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.

2. 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.

3. 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.

4. Risk Management Committee, Credit Policy Committee, Asset Liability Committee, etc are such committees that handle the risk management aspects.

5. 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.

6. Regarding use of risk management techniques, it is found that internal rating system and risk adjusted rate of return on capital are important.
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