OVERVIEW OF RISK MANAGEMENT FOR BANKING COMAPNAY

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Abstract:

Risk is key factor for banking company like other business organization.Because we cannot get profit from any business activity without risk. The potential for loss, either directly through loss of earnings or capital or indirectly through the imposition of constraints on an organisation‘s ability to meet its business objectives‖. Such constraints pose a risk by limiting a bank‘s ability to conduct its ongoing business or to take advantage of opportunities to enhance its business.

Banking risks are a source of unpredicted expenses or losses arise due to many factors.

The present paper analyzes a series of general aspects regarding banking risk and their management.The healthy growth of any nation's economy depends on the healthy growth of that nation's banking sector. Risk management is an important aspect of bank's policies.Risk is the possibility of decrease in economic benefit in the event of monetary loss or loss related to a transaction or activity of a bank.This paper also focused on the various trends or factors which have added risk to banking sector in past years and various measures.There are so many principle which are necessary for proper risk management.

Key Terms: Risk Mangement,Globalisation, Merger and acquisition, BASEL II capital accord

Introduction

In an increasingly complex environment, defined by constant change and intense competition, the banking industry today is undergoing a metamorphosis. Banks toady have assumed a very professional form, the key being balanced the entire applecart – the expectations of various stakeholders in the chain – right from the shareholders to the consumers. This together with the broader macro environment makes the task a very difficult one indeed.

In this complex scene we have identified a few trends, which have added to the risks the banking industry is facing over the past few years.

- **Expanding business arenas**: In a deregulated, banking organisations are providing a much broader and deeper range of products and services, including underwriting and dealing in securities, managing and selling shares in mutual funds, and offering various types ofinsurance. This essentially has led to complexities in the banking system.
- **Globalisation**: Globalisation has permeated the banking scene, and led to a scenario where risks could emerge from any nook and corner across the globe. Today, an economic shock in South East Asia could shake thebalance sheets of banks in America. Thus globalisation has added to the volatility on the scene.
- **Technology:** Technology has redefined banking of the 21st century. High speed information flows across borders have catalyzed the emergence of a global banking system, essentially implying integration of the world banking system. Technology has nevertheless increased risk – although human error and frauds have existed since long, they take a larger dimension in wake of this factor. Errors or frauds could be of huge magnitudes, even enough to bring mammoth banking organisation.

On the other, has led to sophisticated of operations and also emergence of advanced
risk management processes.

Regulatory development: Basel II implementation will be the key regulatory development to watch in the near future (March 2014). This is considered later in this paper, and as far as other issues go, suffice it to say that there is unanimous progress towards deregulation all across, but on the other hand it is counter balanced by an increased regulatory burden.

Business transformation: Merger and acquisition, new geographies, cultural conflicts, operational integration all can strain banking operations, particularly in a global scene. Thus as the industry moves towards consolidation, we will witness an increasing compounding risks.

Streamlining of operations: Lean and mean structures are the order of the day and technology has pushed the concept further. Somewhere, in this rush for downsizing there is a _risk' of adequate risk management being put in the backburner.

Integrated product and service lines: Customisation is the buzzword in banking today, and we are witnessing the emergence of integration across product and services – aimed to satisfy the glo-cal customer. This means, higher due to compounding. Evidently, these factors have made risk management a critical issue. Today there is a heightened activity in the area of risk management. Having established the critically of the risk management, we seek to proceed further in defining an operational definition of risk and examine critically the concept of risk management in context.

Risk

A simple operational definition of risk would be ―The potential for loss, either directly through loss of earnings or capital or indirectly through the imposition of constraints on an organisation's ability to meet its business objectives‖. Such constraints pose a risk by limiting a bank's ability to conduct its ongoing business or to take advantage of opportunities to enhance its business. Risks, by their very nature are associated with uncertainty. Thus they have an expected loss and unexpected loss component. Among the four types of risks mentioned above, the most common and the one requiring the most active risk management is the financial risk.

Classification of Risks

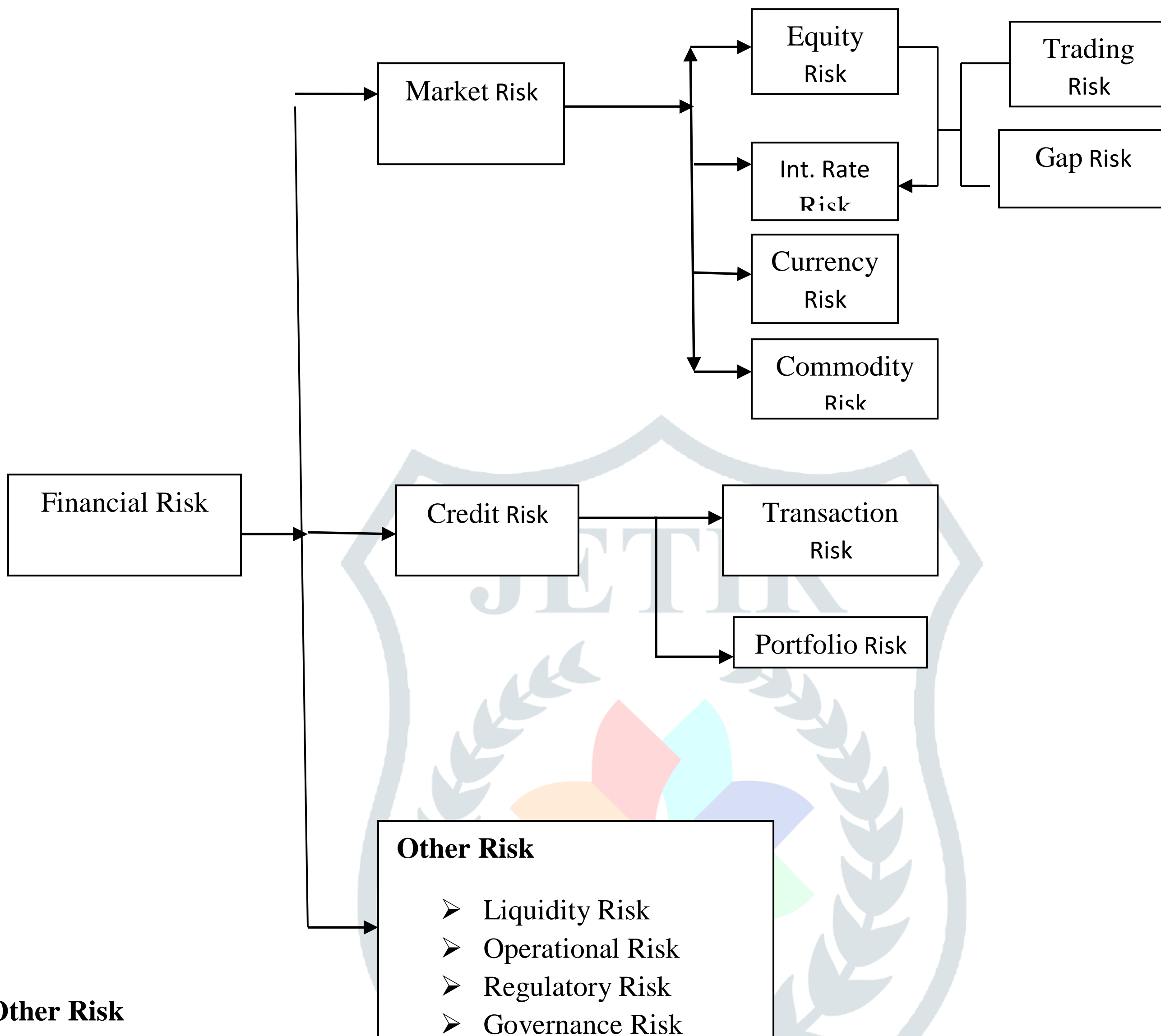
Risks can be put under four main classes:-

Operational risk	**Financial risk**
▪ Process risk ▪ IT risk ▪ Control system ▪ Human capital risk ▪ Health and safety ▪ Compliance risk	▪ Market risk ▪ Credit risk ▪ Liquidity risk ▪ Related operational risk ▪ Regulatory risk ▪ Governance risk
Hazard risk	**Strategic risk**
▪ Property risk ▪ Liability risk ▪ Natural disasters ▪ Political risks	▪ M&As risk ▪ Business risk ▪ Competitor risk ▪ Customer risk ▪ Brand risk ▪ Legal risk ▪ Political risk ▪ Image risk

Financial risk can be again classified into the following types:-

Market risk is the financial risk of uncertainty in the future market value of a portfolio of assets and/or liabilities. Although the most common market risk is the interest rate risk, other forms are – commodity price risk, price risk, currency risk and equity risk.

Credit risk is the risk resulting from the uncertainty in the counterparty's ability or willingness to meet its contractual obligations. Credit risk can take form of transaction risk (risk due to time delays between entering and settling a contract) or portfolio concentration risk (additional risk due to one to one obligor).



Other Risk

- **Liquidity risk** results fro ... he bank. This can be specific (to the bank) or Systemic (common to all b ... example of liquidity crisis in a bank was Global trust Bank, which suffered from liquidity crisis – compounding its credit risk.

- **Operations risk** is defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and system or from external events.

Risk management

Risk management is the process by which a bank identifies, measures, monitors and controls its risk exposures. Risk management encompasses all of the activities of the bank that affect its risk profile.

The objective of risk management is not risk elimination. Rather, it is the optimisation of risk/return trade-off by either maximising return for a given level of risk or minimising the risk required for a desired level of return. Other risks are often a part of costs (like compliance risk). The overall goal of risk management is enhance shareholders value while addressing the objectives of a firm‘s stakeholders (customers, management, employees, boards and shareholders, supervisors and rating agencies, investors, creditors and counterparties). Thus proper risk assessment, analysis and management will not take place unless it is woven into strategic process, operating plans, budgeting process and business decisions.

Risk management – A strategic perspective

The financial services round table of the United States of America, Based on the Basel guidelines, has come up with 7 core principles for risk management, at a strategic level. Banks today realise that effective risk management process can be a significant level. Banks today realise that effective risk management process can be a significant source of competitive advantage – this has led to a rethink on a part of the banks to look at risk management with a strategic perspective.

The principles of risk management so defined are:--

- Commitment and responsibility of the top management
- Developing a framework for managing risk
- Integration of risk management
- Ensuring business line accountability
- Risk evaluation/measurement
- Independent review
- Contingency planning

There are a few generic fallouts of such an approach, which would effectively guard the bank against risk at a strategic level.

These are:-

- Organisation wise understanding of risk
- Ensuring that risk are within tolerances established by the board of directors
- Risk taking decisions are consistent with strategic business objectives
- Risk taking decisions are explicit and clear
- The expected return compensates for the risk exposures

Since effective risk management is a strategic necessity and a core competency, there
is a trend towards more proactive, comprehensive, formal and consistent risk management approaches. Participants are aware of new issues and are enabled by new technology, better information, and new techniques of assessing, measuring, monitoring and controlling individual risks and interactions. This new attitude towards risk management is the comprehensive risk management focus.

Risk management – An operational perspective

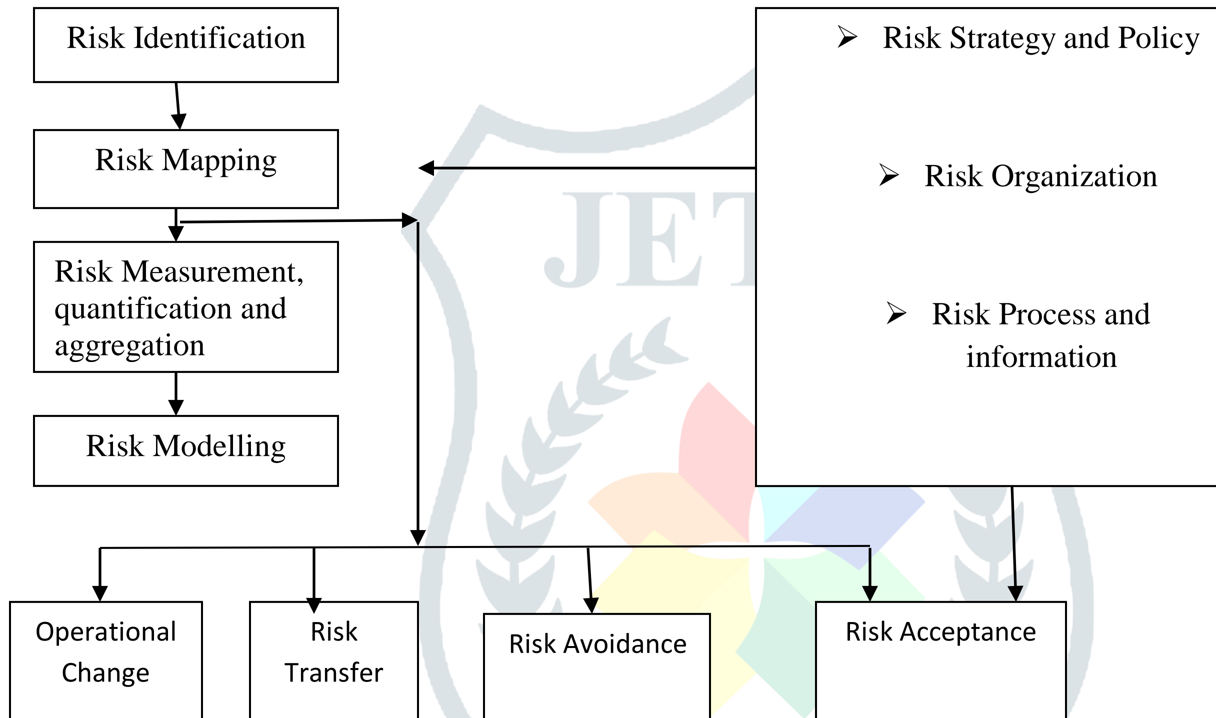
The process of risk management essentially consists of the following steps:-

- **Identification of risks and risk mapping**
  Essentially the first step in risk management would be the identification, categorisation and mapping of risks. Identification of risks, the key step here essentially hinges on the inter business line and functional coordination and management of information flows. Risks are mapped based on the frequency or likely hood of their occurrence against impact they are likely to have an organisation. This will help establish priorities for the organisation (Selection and Aggregation).
- **Risk quantification and modelling**
  The crux of the analytical processes, risk quantification and modeling are purely technical processes where using probabilities models (Dynamic risk simulation, for instance), risks are quantified. Quantification of risk will lead to efficient decision making. Each risk must be modelled in term of volatility and value. The risk profile here must come from the top management. Modelling must be internally validated.
- **Risk profiling**
  Risk profiling is a more elaborate task. It involves working on the risk return profiles based on probability of occurrence and impact it will have on the organisation.
- **Generation of solutions**
  Based on risk profiling, solutions are generated. The solutions may be:-
  - Risk Avoidance

- Risk Transfer
- Risk Acceptance

➢ **Monitoring and updating**

Monitoring and updating are continuous processes. Once again, when the factors affecting the risk profile of an organisation are identified and well communicated internally, the process of monitoring becomes a very smooth task. A well oiled machinery of information flows and reporting, which is the responsibility of the top management, is critical to the task.



The process of Risk Management

Please refer to the supplement under this framework for the management of market, credit and operational risk. We now proceed on to understand one of the key regulatory issues addressing the concept of risk and risk management- the Basel II accord.

BASEL II CAPITAL ACCORD

BASEL II Accord: The structure

The Basel II comprises of three mutually reinforcing pillars meant to contribute to the safety and soundness of the financial system:

- **First pillar**: Minimum capital requirement
- **Second pillar**: supervisory review process
- **Third pillar**: Market discipline

➢ **The first pillar: Minimum capital requirement**

This sets out a minimum capital requirement of 8% of capital to risk weighted assets, and incorporates improvements in the calculation of capital adequacy:

Total capital (unchanged)/ credit + market + operational risk = Bank capital ratio (minimum 8%)

Basel II also provides a menu of approaches for measuring credit risk, market risk,

and operational risk.

A menu of approaches to measure

Credit risk	Market risk	Operational risk
Standardisedapproach (modified version of the existing approach)	Standardised approach	Internal models approach
Foundation internal rating based approach	Internal models approach	Standardised approach
Advanced internal rating based approach		Internal measurement approach

Basel II Approaches

The standardised approach for credit risk

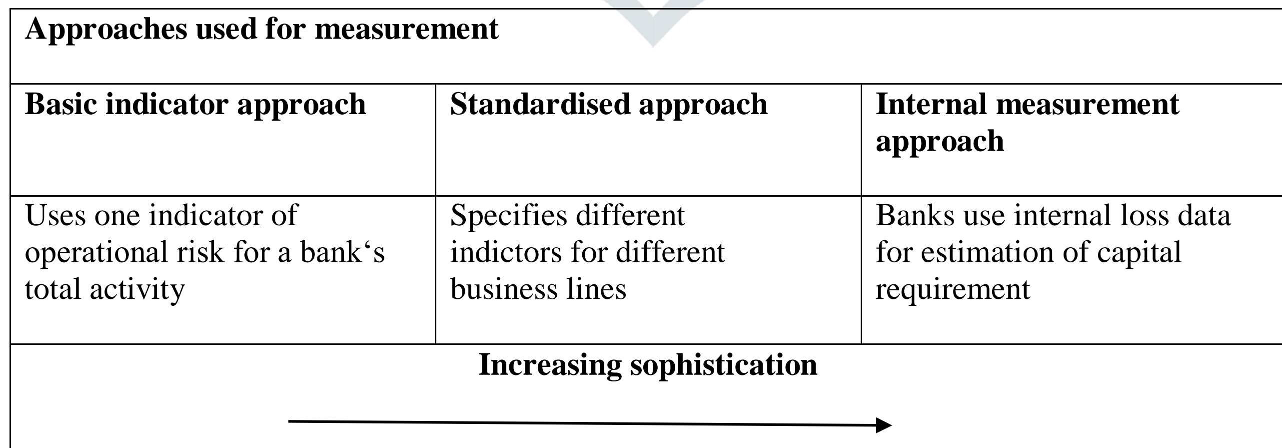
Under this approach the bank assigns a risk weights to each of its assets and offbalance sheet positions and produces a sum of risk weighted assets values. The risk weights are to be redefined by reference to a rating (provided by a rating agency) that meets strict standards.

The internal rating based approach

Here, the bank estimates each borrower‘s creditworthiness and estimates the potential future loss amount to calculate the minimum capital requirement. As a greater range of risk weights are employed, this approach is more risk sensitive.

This frame work allows for both a foundation method and more advanced methodologies. While in the foundation methodologies, banks estimates the probability of default associated with each borrower and the supervisors will supply the other inputs, in the advanced methodology, a bank with a sufficiently developed internal capital allocation process is permitted to supply other necessary inputs as well.

Measurement of operational risk



Approaches used for measurement		
Basic indicator approach	**Standardised approach**	**Internal measurement approach**
Uses one indicator of operational risk for a bank‘s total activity	Specifies different indictors for different business lines	Banks use internal loss data for estimation of capital requirement
Increasing sophistication →		

- **The Second Pillar: Supervisory review process**

This requires supervisors to ensure the presence of sound internal processes in a bank for the assessment of capital adequacy based on the risk profile. While banks develop an internal capital assessment process, supervisors evaluate how well they assess their capital adequacy needs relative to their risks, and intervene where necessary.

- **The Third Pillar: Market discipline**

The rationale for this pillar is to bolster market discipline through enhanced disclosure by banks as it ensures that market participants can be better understand banks' risk profiles and capital adequacy positions.

Basel II puts forth disclosure requirements and recommendations in several areas, including the way a bank calculates its capital adequacy and its risk assessment methods.

The core set of disclosure recommendations applies to all banks, with more detailed requirements for supervisory recognition of internal methodologies for credit risk, credit risk mitigation techniques and asset securitization.

Conclusion:

Risk is an opportunity as well as a threat and has different meanings for different users. Banks cannot function without taking risk on the one hand and on the other hand no organization is immune to risk. Risk management involves the maintenance of losses and the value of the bank to within accepted margins. Types of risk include market risk, operational risk, liquidity risk and credit risk etc.Each organization's risk change constantly. So banking risk management is an ever changing process shaped by general factors such as the institution objectives,financila trends and government regulation, structure and cost of liabilities, structure and return of assets and the size and source of risk assumed by each assets and liability items.

In short banking risk management will continue to grow from minor factor to major factor in banking management.

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