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Bank Risk Management

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Introduction

Risk is associated with uncertainty and reflected by way of charge on the fundamental/ basic foremost thing is to understand the risks run by the bank and to ensure that the risks are properly confronted, effectively controlled and rightly managed. Each transaction that the bank undertakes changes the risk profile of the bank. The extent of calculations that need to be performed to understand the impact of each such risk on the transactions of the bank makes it nearly impossible to continuously update the risk calculations. Hence, providing real time risk information is one of the key challenges of risk management exercise. Till recently all the activities of banks were regulated and hence operational environment was not conducive to risk taking. Better insight, sharp intuition and longer experience were adequate to manage the limited risks. Profiting in business without exposing to risk is like trying to live without being born. Every one knows that risk taking is failure prone as otherwise it would be treated as sure taking. Hence risk is inherent in any walk of life in general and in financial sectors in particular. Of late, banks have grown

Need of the study

Till recently, due to regulated environment, banks could not afford to take risks. But of late, banks are exposed to same competition and hence are compelled to encounter various types of financial and non-financial risks. Therefore it is needed to study the various aspects of bank risk managements.

Objectives

- To find out various risks factors in bank.
- To study the present functioning of the bank in that respects.
- To study the procedure of handling of different types of risk.
- To study the regulations of RBI while handling the bank risk.

Hypothesis

Various risks in banks are avoidable with the help of efficient Management Information System and its regulatory control

Methodology

Secondary data is collected through various books and journals. Information has been properly analysed.

Data analysis

Risk is inherent in any walk of life in general and in financial sectors in particular.. Risks and uncertainties form an integral part of banking which by nature entails taking risks. There are three main categories of risks; Credit Risk, Market Risk & Operational Risk. . Main features of these risks as well as some other categories of risks such as Regulatory Risk and

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Environmental Risk. Various tools and techniques to manage Credit Risk, Market Risk and Operational Risk and its various components, are also discussed in detail. , Risk Aggregation & Capital Allocation and Risk Based Supervision (RBS), in managing risks in banking sector. Risks and uncertainties form an integral part of banking which by nature entails taking risks. Business grows mainly by taking risk. Greater the risk, higher the profit and hence the business unit must strike a trade off between the two. The essential functions of risk management are to identify measure and more importantly monitor the profile of the bank. While new avenues for the bank has opened up t hey have brought with them new risks as well, which the banks will have to handle and overcome.

***Credit Risk* -** Credit Risk is the potential that a bank borrower/counter party fails to meet the obligations on agreed terms. There is always scope for the borrower to default from his commitments for one or the other reason resulting in crystallization of credit risk to the bank. These losses could take the form outright default or alternatively, losses from changes in portfolio value arising from actual or perceived deterioration in credit quality that is short of default. Credit risk is inherent to the business of lending funds to the operations linked closely to market risk variables. The objective of credit risk management is to minimize the risk and maximize bank's risk adjusted rate of return by assuming and maintaining credit exposure within the acceptable parameters. Credit risk consists of primarily two components, viz Quantity of risk, which is nothing but the outstanding loan balance as on the date of default and the quality of risk, The management of credit risk includes a) measurement through credit rating/ scoring, b) quantification through estimate of expected loan losses, c) Pricing on a scientific basis and d) Controlling through effective Loan Review Mechanism and Portfolio Management.

Portfolio Management The need for credit portfolio management emanates from the necessity to optimize the benefits associated with diversification and to reduce the potential adverse impact of concentration of exposures to a particular borrower, sector or industry. Stipulate quantitative ceiling on aggregate exposure on specific rating categories, distribution of borrowers in various industry, business group and conduct rapid portfolio reviews. The existing framework of tracking the non-performing loans around the balance sheet date does not signal the quality of the entire loan book. There should be a proper & regular on-going system for identification of credit weaknesses well in advance. Initiate steps to preserve the desired portfolio quality and integrate portfolio reviews with credit decision-making process.

Loan Review Mechanism This should be done independent of credit operations. It is also referred as Credit Audit covering review of sanction process, compliance status, review of risk rating and pick up of warning signals and recommendation of corrective action with the objective of improving credit quality. . This is done to bring about qualitative improvement in credit administration. Identify loans with credit weakness. Determine adequacy of loan loss provisions. Ensure adherence to lending policies and procedures. The focus of the credit audit needs to be broadened from account level to overall portfolio level. Regular, proper & prompt reporting to Top Management should be ensured. Credit Audit is conducted on site, i.e. at the branch that has appraised the advance and where the main operative limits are made available. However, it is not required to visit borrower's factory/office premises.

Risk Rating Model — Disciplined way of looking at Credit Risk. — Impact of a new loan asset on the portfolio can be assessed. Taking a fresh exposure to the sector in which there already exists sizable exposure may simply increase the portfolio risk although specific unit level risk is negligible/minimal. Instead of passive approach of originating the loan and

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holding it till maturity, active approach of credit portfolio management is adopted through securitization/ credit derivatives. — Pricing of credit risk on a scientific basis linking the loan price to the risk involved therein. The unsystematic risk arises out of internal factors such as machinery breakdown, labor strike, new competitors who are quite specific to the activities in which the borrower is engaged. The key ingredient of credit risk is the risk of default that is measured by the probability that default occurs during a given period.

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. Market Risk Management provides a comprehensive and dynamic frame work for measuring, monitoring and managing liquidity, interest rate, foreign exchange and equity as well as commodity price risk of a bank that needs to be closely integrated with the bank's business strategy. Scenario analysis and stress testing is yet another tool used to assess areas of potential problems in a given portfolio. Identification of future changes in economic conditions like – economic/industry overturns, market risk events, liquidity conditions etc that could have unfavorable effect on bank's portfolio is a condition precedent for carrying out stress testing. As the underlying assumption keep changing from time to time, output of the test should be reviewed periodically as market risk management system should be responsive and sensitive to the happenings in the market.

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. Hence, the objective of interest rate risk management is to maintain earnings, improve the capability, ability to absorb potential loss and to ensue the adequacy of the compensation received for the risk taken and affect risk return trade-off. Management of interest rate risk aims at capturing the risks arising from the maturity and re-pricing mismatches and is measured both from the earnings and economic value perspective.

Operational Risk **-** Always banks live with the risks arising out of human error, financial fraud and natural disasters. Exponential growth in the use of technology and increase in global financial inter-linkages are the two primary changes that contributed to such risks. Operational risk, though defined as any risk that is not categorized as market or credit risk, is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events. In order to mitigate this, internal control and internal audit systems are used as the primary means. Risk education for familiarizing the complex operations at all levels of staff can also reduce operational risk. Insurance cover is one of the important mitigators of operational risk. Operational risk events are associated with weak links in internal control procedures. The key to management of operational risk lies in the bank's ability to assess its process for vulnerability and establish controls as well as safeguards while providing for unanticipated worst-case scenarios. Operational risk involves breakdown in internal controls and corporate governance leading to error, fraud, performance failure, compromise on the interest of the bank resulting in financial loss. Putting in place proper corporate governance practices by itself would serve as an effective risk management tool.

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Bank should strive to promote a shared understanding of operational risk within the organization, especially since operational risk is often interwined with market or credit risk and it is difficult to isolate. Over a period of time, management of credit and market risks has evolved a more sophisticated fashion than operational risk, as the former can be more easily measured, monitored and analysed. And yet the root causes of all the financial scams and losses are the result of operational risk caused by breakdowns in internal control mechanism and staff lapses. .

Environmental Risk - As the years roll by and technological advancement take place, expectation of the customers change and enlarge. With the economic liberalization and globalization, more national and international players are operating the financial markets, particularly in the banking field. This provides the platform for environmental change and exposes the bank to the environmental risk. Thus, unless the banks improve their delivery channels, reach customers, innovate their products that are service oriented; they are exposed to the environmental risk resulting in loss in business share with consequential profit. Principles for effective banking supervision in the form of minimum requirements to strengthen current super- visory regime, were mooted.

Case study

Under the case analysis we have selected the Union Bank Of India and studied in detail the various risk faced by the bank and what policies formulated by the bank while handling the same with specific policies.

Risk is inherent part of Bank's business. Effective Risk Management is critical to any Bank for achieving financial soundness. In view of this, aligning Risk Management to Bank's organizational structure and business strategy has become integral in banking business. Over a period of year, Union Bank of India (UBI) has taken various initiatives for strengthening risk management practices. Bank has an integrated approach for management of risk and in tune with this, formulated policy documents taking into account the business requirements / best international practices or as per the guidelines of the national supervisor. These policies address the different risk classes viz., Credit Risk, Market Risk and Operational Risk. The issues related to Credit Risk are addressed in the Policies stated below;

Loan Policy.	Credit Monitoring Policy.
Real Estate Policy.	Credit Risk Management Policy.
Collateral Risk Management Policy.	Recovery Policy.
Treasury Policy.	
Operational Risk Management Policy.	Business Continuity Policy.
Outsourcing Policy.	Disclosure Policy.

Besides, the above Board mandated Policies, Bank has detailed 'Internal Control Principles' communicated to the business lines for ensuring adherence to various norms like Anti-Money Laundering, Information Security, Customer complaints, Reconciliation of accounts, Book-keeping etc.

Oversight Mechanism:

- Board of Directors has the overall responsibility of ensuring that adequate structures, policies and procedures are in place for risk management and that they are properly

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implemented. Board approves risk management policies and also sets limits by assessing our risk appetite, skills available for managing risk and our risk bearing capacity.

- Board has delegated this responsibility to a sub-committee: the Supervisory Committee of Directors on Risk Management & Asset Liability Management. This is the Apex body / Committee is responsible for supervising the risk management activities of the Bank.
- Further, Bank has the following separate committees of top executives and dedicated Risk Management Department:
- Credit Risk Management Committee (CRMC): This Committee deals with issues relating to credit policies and procedure and manages the credit risk on a Bank-wide basis.
- Asset Liability Management Committee (ALCO): This Committee is the decision-making unit responsible for balance sheet planning and management from the angle of risk-return perspective including management of market risk.
- Operational Risk Management Committee (ORMC): This Committee is responsible for overseeing Bank's operational risk management policy and process.
- Risk Management Department of the Bank provides support functions to the risk management committees mentioned above through analysis of risks and reporting of risk positions and making recommendations as to the level and degree of risks to be assumed. The department has the responsibility of identifying, measuring and monitoring the various risk faced the bank, assist in developing the policies and verifying the models that are used for risk measurement from time to time.

Finding

Banking is nothing but financial inter-mediation between the financial savers on the one hand and the funds seeking business entrepreneurs on the other hand. As such, in the process of providing financial services, commercial banks assume various kinds of risks both financial and non-financial.

Conclusion

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. It also prevents an institution from suffering unacceptable loss causing an institution to fail or materially damage its competitive position. 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. There may not be one-size-fits-all risk management module for all the banks to be made applicable uniformly. Balancing risk and return is not an easy task as risk is subjective and not quantifiable where as return is objective and measurable. If there exist a way of converting the subjectivity of the risk into a number then the balancing exercise would be meaningful and much easier.

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Therefore, banking practices, which continue to be deep routed in the philosophy of securities, based lending and investment policies, need to change the approach and mindset, rather radically, to manage and mitigate the perceived risks, so as to ultimately improve the quality of the asset portfolio. As in the international practice, a committee approach may be adopted to manage various risks. Risk Management Committee, Credit Policy Committee, Asset Liability Committee, etc are such committees that handle the risk management aspects. While a centralized department may be made responsible for monitoring risk, risk control should actually take place at the functional departments as it is generally fragmented across Credit, Funds and Investment and Operational areas. Integration of systems that includes both transactions processing as well as risk systems is critical for implementation. In a scenario where majority of profits are derived from trade in the market, one can no longer afford to avoid measuring risk and managing its implications thereof. Crossing the chasm will involve systematic changes coupled with the characteristic uncertainty and also the pain it brings and it may be worth the effort.

The engine of the change is obviously the evolution of the market economy abetted by unimaginable advances in technology, communication, transmission of related uncontainable flow of information, capital and commerce through out the world. Like a powerful river, the market economy is widening and breaking down barriers. Government's role is not to block that flow, but to accommodate it and yet keep it sufficiently under control so that it does not overflow its banks and drown us with the associated risks and undesirable side effects. To the extent the bank 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. What can be measured can mitigation is more important than capital allocation against inadequate risk management system. Basel proposal provides proper starting point for forward-looking banks to start building process and systems attuned to risk management practice. Given the data- intensive nature of risk management process, Indian Banks have a long way to go before they comprehend and implement Basel II norms, in to-to

Recommendation

It is recommended that RBI should structure the risk profile templates to enable the bank to make a self-assessment of their risk profile. It is designed to ensure continuous monitoring and evaluation of risk profile of the institution through risk matrix. This may optimize the utilization of the supervisory resources of the RBI so as to minimize the impact of a crises situation in the financial system. .

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