Risk Management Practices In Banks — The Best Is Yet To Come

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Today's banking is full of risks. So do not try too hard to avoid it because to stay in business is to stay with risk. What is required is to convert vulnerabilities and weaknesses into strengths and threats as opportunities to build a sustainable development in banking sector. Though we have achieved a lot, the best is yet to come.

The emergence of 'risk management' as an 'organised effort' is only a recent phenomenon that happened especially after the opening up of the banking sector to the private and outside players in the wake of banking sector reforms. Why has that been so? Why even the elementary risk management practices had not been integrated in the functioning of banks earlier? A little introspection may provide the answer to this very simple but vital question. The first reason had been excessive 'State intervention' in the functioning of banks and the neglect of risk management strategy and its application. There had been 'directed lending', administered interest rates, target oriented performance emphasising expansion and extension, meeting of credit targets irrespective of the attendant risks. The bank managements felt that their performances are to be evaluated on the basis of their achieving the target set for, and that they can sacrifice the profitability and associated risk in meeting their targets.

The second reason had been the banking policy in vogue in that regime. The banking policy was primarily influenced by the economic planning strategy formulated under different five-year plans wherein banks were projected mainly as the provider of capital to various tasks and projects envisaged in the plans by suitable resource mobilisation. Further, banks were required to disburse soft and easy loans and financial assistance to poor and less developed sections of the society to augment their income generation capability without proper and adequate security under several government-sponsored schemes. In fact, the 'social banking' had become the overriding goal.

Another contributory factor was the accounting system. Under the accrual system of accounting and the disclosure norms, even bad loans were being carried forward as good loans for years together while non-recoverable interest incomes were shown as income without their proper provisioning. All these policies and practices helped the banks project their financial positions in a glorified way, hiding the actual state of affairs.

Lastly, it may not be out of place to question even the role of Reserve Bank of India (RBI) at that point of time.

The New Challenge

Past is past. The current Indian banking scenario is healthy and resurgent, thanks to the financial sector reforms. A series of policy initiatives and measures have enabled banks to be in a position to function with highest operational freedom, accountability and transparency, leading to greater customer-satisfaction. Entry of private and foreign players in Indian banking space, end of the detailed control on lending and deposit including fixation of their price, and Reduction of CRR and SLR to make more fund available to the bankers for their business, have all contributed to the present robustness of banking sector in India. Introduction of new mechanisms like debt recovery tribunal, one-time settlement scheme and enactment of new acts like Securitisation Act have tightened legal arrangements for recovery of NPAs. Further, new accounting and prudential norms relating to income recognition, provisioning and capital adequacy have been introduced as part of a comprehensive drive to improve upon the financial health of the banks and to regain the investor confidence. And to cap it all, even the public sector banks have been allowed access to the capital markets to raise their capital and many such banks have already raised huge funds to strengthen their

capital base through this route.

Thus, given the current scenario, the banks can no longer say that they do not have the freedom to operate their businesses as they like. It is the time they meet the twin objectives of profitability and safety of their assets. Banks will have to take charge of the major area of risk management for their own survival and growth. To cope up with these changes in the external environment and to meet the internal requirement, banks have to develop skills for managing newer types of risks, market risks, interest rate risks, foreign exchange risks, liquidity risks, in addition to traditional credit risks. The situation has further been aggravated in the context of present fluidity of international capital markets and the increased vulnerability of developing economies to sharp fluctuations in macro economic situations. Generally, the bank failures in many countries have largely been due to non-existence of proper risk management system or due to its improper functioning. Another vital trend is that owing to decrease in the spread (difference between interest incomes and interest expenses) arising out of stiff competition, banks have no other alternative but to enter into other risky areas of business and thereby increase the quantum and variety of risks involved. Today's banking rests mainly on maintaining an optimum balance among risks, profitability and growth. There is no other option in this game. Accordingly, banks need to put in place comprehensive framework for risk management duly matched with its variance of business profile and database in their command. Gradually, with the contemporary changes, the whole process will have to be consolidated further to meet the test of time. The awareness of healthy banking that had seeped into all levels of banking establishment replacing a sense of complacency prior to 1990, may be regarded as the single most vital contribution of the financial sector reforms.

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New Risk Management Paradigm

(1). Adopting suitable and appropriate strategies and formulation of adequate policies towards risk management should be systematically encouraged and developed starting from Board level to all downwards levels. It is also to be considered as a conscious policy objective at the regulator's level. This matter was taken up for discussion in the Basel Committee meeting held in September 1997 and it was decided that a suitable risk management policy should be adopted by all central banking institutions vis-à-vis the institutions they regulate. Thus in India, both RBI and the respective banks are equally

responsible for implementing risk management system. Hence, proper initiative should be taken by RBI to integrate into its overall regulatory and supervisory framework the risk management policies and practices and the individual banks are to incorporate the same into their internal management. In an attempt to accomplish its role, RBI issued a detailed guideline in this regard in October 1999 for implementation of risk management in banks embracing broadly, the areas of credit, market and operational risks. Regarding credit risks, the RBI suggested that each bank should finalise a loan policy covering the methodologies for measurement, monitoring and control of credit risk duly approved by its board of directors. The portfolios should be evaluated on an ongoing basis rather than near about the balance sheet date. Current and potential risk exposures should be monitored on a daily basis.

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(2) Internal checks and internal control measures should be enhanced properly to prevent possible frauds or falsification of accounts due to employee infidelity or system lapse. Unresolved problems of un-reconciled inter-branch accounts, disputed debits to customers etc., should be properly addressed.

(3) Application of information technology in banks should be considered as the most effective management tool and as such automation of banking operations and networking of branches should be taken up on top priority basis backed up by proper planning and adequate resource allocation.

(4) It is to be recognised that banking is a specialised type of activity. Since banks have to handle large amount of other people's money and earn profits they should know how to assess credit and how to keep accounts. Proper training and development is needed to train the employees in the relevant disciplines. This is to be taken care of both at the recruitment level as well as after recruitment by arranging proper on the job training and specialisation through learning by doing.

(5) Promotion and transfer policy should be redesigned considering the need and job skills required for effective performance and safeguarding the organisational efficiency. A person handling foreign currency matters in a foreign branch should not be transferred to a rural branch all a sudden simply on the ground that he or she has completed some given number of years at that particular assignment

in the name of uniform policy implementation.

(6) No two institutions are alike when it comes to devising business risk management strategies and its adaptabilities with its organisational characteristics though all banks are guided by same business goals backed by the same regulation and supervision framework. Organisation-specific risk management strategies have to be developed according to the business mix, geographical segment covered, staff culture and detailed work practices in vogue in the respective banks. There should be some uniformity to match with the statutory regulations and supervision requirements but any point requiring special attention or special arrangement should not be lost sight of.

(7) As the board of directors is the final authority to define and determine the risk strategies of a bank, it should review overall business objectives and the associated risks from time to time and advise the lower levels of management regarding quantum and variety of risks that can be accepted by the bank and issue necessary directives in this respect.

(8) Lines of authority for sanctioning of loans and advances to be specified at executive levels or committee thereof encompassing desirable system to be followed with the standards of measuring risks.

(9) Before introducing any new product or service, its complexities and the associated risks should be thoroughly examined, suitable risk monitoring and risk containment policies laid down and appropriate internal control measures developed. Officers and staff responsible for its functioning should be guided properly through in-house circulars, face-to-face discussion and issuance of requisite clarifications so that no mistake is committed in processing the loan proposal and monitoring the status of loan sanctioned on this account.

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(10) The credit policy approved by the board, should also cover the guidelines in regard to placement and posting of experienced and well-trained officers in credit department. Officers should be posted to credit department after they have put in certain minimum number of years of service and after acquiring sufficient exposure in credit appraisal techniques.

(11) It has been found that in many cases funds sanctioned by the banks for a particular purpose were diverted by certain unscrupulous borrowers, thereby making the

loan prone to become 'non-performing'. The banks have to develop appropriate ways and means to ensure that end use of funds particularly in respect of large borrowers. This loan review mechanism has to be effected on a regular basis so that weaknesses developed in the accounts may be suitably dealt with for corrective action.

(12) For better co-ordination of activities and control of risk, an efficient and effective internal management reporting system should be put in place. The reports should be comprehensive enough for meaningful analysis and effective interpretation. The reports generated from the system should be reviewed at short intervals and suitable guidelines may be issued to the operating levels.

Each bank should appreciate that in an extremely competitive and fast changing environment, the key to success is to firmly put in place a comprehensive risk management system. Crisis management or contingency planning would never help and only add to embarrassment, expenses and loss of time. Crisis management may be found helpful to protect against the downside but could not act as a guide to improvement and to attain the goal. Similarly, contingency planning helps to be flexible enough to follow alternative plan to counter the unforeseen surprises in the chosen plan. Both these short term options might help us reduce the negative impact but can never guide us reach the right destination.

Today's banking rests mainly on maintaining an optimum balance among risks, profitability and growth. There is no other option in this game. Accordingly, banks need to put in place comprehensive framework for risk management duly matched with its variance of business profile and database in their command

Risk Management And Analysis

Risk management is basically identification, measurement, analysis and control of risks arising from the business in an attempt to alter in a desirable manner the states a system may reach and their probabilities or manage their consequences. "A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of this value". Risk management requires preparedness and quick reflexes to launch pre-emptive moves to counter emerging, altered scenarios.

In running a business, maximisation of profit should not be the only goal, but its maintenance on a sustainable basis is all the more important. So a firm should focus its strategy on risk-adjusted rate of return. The return has to be adjusted for the various types of risks associated with the business — be it lending or investing activities or issue of letter of credit.

Risk is contingent on a number of factors and accordingly there may be various types of risks and there is no end to its classification. But basically, in case of banks, we come across three major categories of risks— market risks, credit risks and operational risks and we shall restrict our discussion to these risks only in this section of our article. Market risks may arise because of movement in prices of commodities, currencies or equities mainly attributed to interest rate, foreign exchange forward trading, investment in shares and bonds and similar derivatives. Credit risk implies the risk due to default in lending and counter party exposures. Operational risk covers a wide range of risks associated with the operation. Basel Committee has defined operational risk as follows:

"the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, systems or from external events." The definition excludes strategic and reputational risk, but includes legal risk. Operational risks may be sub-divided into the following categories:

(a) Information technology risk-- System failure, Internet virus, inaccurate data, poor quality of communication, etc.

(b) Human resource risk – Lack in recruitment procedure, incompetent staff, holiday policy, etc.
(c) Loss to assets risks — Risks of damage of assets and interruptions in business due to fire, flood, earthquake or other natural calamities.
(d) Relationship risk — Loss arising out of changes in the relationships among different components of business such as changes in regulation, claims, customer satisfaction, lawsuit, etc.

Measurement of the expected risk is not a very easy task as there is no absolute reliable methodology. It is a mixture of art and science. There is wide variation in the range of accuracy in measuring different categories of risks. Market risks can be measured almost to the extent of 90 per cent of the total risk reliably with the use of VaR (Value at risk) technique. But in the case of credit risk, about 30 to 40 per cent of the total risks could be quantified. Other techniques used in the measurement and analysis include 'stress testing', 'back testing' and 'scenario analysis'. Stress testing addresses the large movements in key market variables that lie beyond the day-to-day monitoring but that could potentially occur. Risk managers select a set of moves for certain major market parameters and then subject the current portfolio to those moves measuring the simulated change in portfolio value. Back testing is the process of comparing actual profit and loss with internally generated risk measures in order to test the efficacy of the internal models. It is not a one-time evaluation of a model but an ongoing process in which at regular interval the number of exceptions over a particular period is noted. Scenario analysis is a strategic technique that enables a firm to evaluate the potential impact on its earning streams of various different eventualities. It uses multiple projections and helps the firm to assess its longer-term strategic vulnerabilities.

For the analysis and management of interest rate risk the major techniques adopted includes, Gap analysis, Duration analysis, Value at Risk (VaR) and simulation technique. Gap is the difference between rate sensitive assets and rate sensitive liabilities. As such it measures the difference between a bank's assets and liabilities and off balance sheet positions, which will be re-priced or will mature within a predetermined period. An

estimate of the average time required before the discounted value or the present values of all cash flows can be recovered by an asset holder including that of bank's depositor is made in Gap analysis method. This concept is applicable for all assets, liabilities and off-balance-sheet items. In a VaR model an estimate is made of the maximum potential loss in a position over a given holding period at a given confidence level. Simulation model tries to determine whether the model adequately captures the bank's current and projected cash flows keeping in view the different interest rates and market price scenarios. It is an interactive process and not an optimisation model.

International best practices should be incorporated in building risk management framework

Determination of operational risks is still in its infancy and no scientific model is available which is quite reliable. However, at present several methods have been used including appropriate statistical distributions to estimate operational VaR. But due to the difficulty in identifying the right statistical distribution that determines the severity and the frequency of a particular category of operational loss, the operational VaR is not easily obtainable. But to determine approximately the severity of operational loss we may take advantage of Extreme Value Theory (EVT) and Monte Carlo Simulation methods.

But in India, banks are facing certain difficulties in employing these statistical models for measuring levels of risks associated with different banking activities. For example, we can mention two to three points;

Firstly, to utilise these statistical models to our best advantage, a strong data-base on several variables is required. But such database is yet to be fully developed. We can take an example; in VaR model we measure the risk that the market value of the portfolio will decline as a result of changes in the interest rates, equity prices or exchange rates. So we need historical data or time series data on these variables. But there is lack of such reliable data. Further, as the financial markets in India are not yet fully developed it is difficult to decide as to which type of probabilistic distribution model is relevant in Indian conditions.

Secondly, to be effective, these models require proper feedback mechanism and appropriate and adequate technological support. But many of the Indian banks are far behind in this regard and this is mainly because of resource constraints.

Thirdly, the skill and knowledge base of the banking personnel in India is yet be matured fully to operate and handle these sophisticated techniques. It requires proper training and adequate experience, which is still wanted at large.

To start with, simple risk management techniques may be employed to overcome these difficulties. And then we can gradually, move to more sophisticated techniques till the requisite skill is developed.

Recommendations

Some points that may help banks to promote their risk management system are as follows:

(a) Risk management should be actively and continuously promoted throughout the organisation to anticipate and mitigate all categories of risks.

(b) Adequate competence should be developed through recruitment, training and development of employees to make them efficiently handle the tools and techniques of modern risk management system.

(c) Proper infrastructure should be put in place supported by appropriate technological back up to facilitate implementation of planned risk management strategy.

(d) International best practices should be incorporated in building risk management framework.

(e) Systems and procedures adopted for risk management should be under constant review for its adaptability to the changing circumstances as well as for their improvements.

(f) Contact and continuous dialogue should be maintained with peer organizations, banking associations, academic bodies and international institutions to stay up to date.

(g) Suitable methods and experiences may be gathered from insurance sector for gainful utilisation. ❐