RISK MANAGEMENT IN INDIAN BANKS: SOME EMERGING ISSUES

Dr. Krishn A. Goyal , Convener & Head, Management Department, Bhupal Nobles'(P.G.) College, Udaipur
Prof. Sunita Agrawal, Director, Pacific Business School, Udaipur (Raj.)

Abstract
The fast changing financial environment exposes the banks to various types of risk. The concept of risk and management are core of financial enterprise. The financial sector especially the banking industry in most emerging economies including India is passing through a process of change. Rising global competition, increasing deregulation, introduction of innovative products and delivery channels have pushed risk management to the forefront of today's financial landscape. Ability to gauge the risks and take appropriate position will be the key to success. This paper attempts to discuss in depth, the importance of risk management process and throws light on challenges and opportunities regarding implementation of Basel-II in Indian Banking Industry.
Keywords: Basel-II,Capital Adequacy Ratio (CAR), Forex, Risk management

\

Introduction

Today, The Indian Economy is in the process of becoming a world class economy. The Indian banking industry is making great advancement in terms of quality, quantity, expansion and diversification and is keeping up with the updated technology, ability, stability and thrust of a financial system, where the commercial banks play a very important role, emphasize the very special need of a strong and effective control system with extra concern for the risk involved in the business. Globalization, Liberalization and Privatization have opened up a new methods of financial transaction where risk level is very high. In banks and financial institutions risk is considered to be the most important factor of earnings. Therefore they have to balance the relationship between risk and return. In reality we can say that management of financial institution is nothing but a management of risk. Managing financial risk systematically and professionally becomes an even more important task. Rising global competition, increasing deregulation, introduction of innovative products and delivery channels have pushed risk management to the forefront of today's financial landscape. Ability to gauge the risks and take appropriate position will be the key to success. It can be said that risk takers will survive, effective risk managers will proper and risk averse are likely to perish.

The risk arises due to uncertainties, which in turn arise due to changes taking place in prevailing economic, social and political environment and lack of non-availability of information concerning such changes.

Risk is an exposure to a transaction with loss, which occurs with some probability and which can be expected, measured and minimized. In financial institutions risk result from variations and fluctuations in assets or liability or both in incomes from assets or payments and on liabilities or in outflows and inflows of cash. Today, banks are facing various types of risks that financial intermediaries are exposed to, in the course of their business, which can be presented through following chart:

Various Types of Risks

Financial Risks		Non-Financial Risks
Credit Risk	**Market Risk**	
☐ Counter Part or Borrower Risk	☐ Interest Rate Risk	☐ Operational Risk
☐ Intrinsic or Industry Risk	☐ Liquidity Risk	☐ Strategic Risk
☐ Portfolio or Concentration Risk	☐ Currency Forex Risk	☐ Funding Risk
	☐ Hedging Risk	☐ Political Risk
		☐ Legal Risk

Credit Risk: Credit risk is defined as the possibility of losses associated with decrease in the credit quality of the borrower or the counter parties. In the bank's portfolio, losses stem from outside default due to inability or unwillingness of the customer or the counter party to meet the commitments, losses may also result from reduction in the portfolio value arising from actual or perceived deterioration in credit quality

Market Risk: Market risk is the risk of incurring losses on account of movements in market prices on all positions held by the banks. Liquidity risk of banks arises from funding of long term assets (advances) by short term sources (deposits) changes in interest rate can significantly affect the Net Interest Income (NII). The risk of an adverse impact on NII due to variations of interest rate may be called interest rate risk. Forex risk is the risk of loss that bank may suffer on account of adverse exchange rate movements against uncovered position in foreign currency.

Non-Financial Risk: Non-financial risk refers to those risks that may affect a bank's business growth, marketability of its product and services, likely failure of its strategies aimed at business growth etc. These risks may arise on account of management failures, competition, non-availability of suitable products/services, external factors etc. In these risk operational and strategic risk have a great need of consideration.

Operational Risk: It may be defined as the risk of loss resulting from inadequate or failed internal process people and systems or because of external events.

Strategic Risk: Strategic risk is the risk that arises from the inability to implement appropriate business plans and strategies, decisions with regard to allocation of resources or adaptability to dynamic changes in the business/operating environment. These are a number of other risk factor through which operations risk, credit risk and market risk may manifest. It should be recognised that many of these risk factors are interrelated, one results to other.

Process of Risk Management: 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 maximising the profit and optimizing the capital funds for ensuring long term solvency of the banking organisation. In the process of risk management following functions comprises:

- Risk identification
- Risk measurement or quantification
- Risk control
- Monitoring and reviewing

Risk Identification: The risk identification involves 1. the understanding the nature of various kinds of risks. 2. the circumstances which lead a situation to become a risk situation and 3. causes due to which the risk can arise.

Risk Quantification: Risk quantification is an assessment of the degree of the risk which a particular transaction or an activity is exposed to. Though the exact measurement of risk is not possible but the level of risk can be determined with the help of risk rating models.

Risk Control: Risk control is the stage where the bank or institutions take steps to control the risk with the help of various tools.

Tools for Risk Control

- Diversification of the business
- Insurance and hedging
- Fixation of exposure ceiling
- Transfer the risk to another party at right time
- Securitisation and reconstruction

Risk Monitoring: In risk monitoring the bankers have to fix up the parameters on which the transaction is to be tested to be sure that there is no risk to viable existence of the financial unit or investment of the bank.

Risk Management in Bank: Basel Committee Approach: In order to help the banks to recognise the different kinds of risks and to take adequate steps to overcome the under capitalisation of banks assets and lessen the credit and operational risks faced by banks. Banks of International Settlement (BIS) set up Basel Committee on banking supervision in 1988, which issued guidelines for updating risk management in banks. These guidelines brought about standardization and universalization among the global banking committee for risk management and seek to protect the interest of the depositors/shareholders of the bank. As per the guidelines issued, capital adequacy was considered panacea for risk management and all banks were advised to have Capital Adequacy Ratio (CAR) at at least 8%. CAR is the ratio of capital to risk weighted assets and it provides the cushion to the depositors in case of bankruptcy. In January 1999, the Basel Committee proposed a new capital accord, which is known as **Basel II**. A sound framework for measuring and quantifying the risk associated with banking operations put by it. The emphasis of New Basel Accord is on flexibility, efficient operations and higher revenues for banks with full acknowledgement of risks. The New Accord makes clear distinction between the credit risk, market risk and operational risk stipulating assessment of risk weightage covering all the three categories

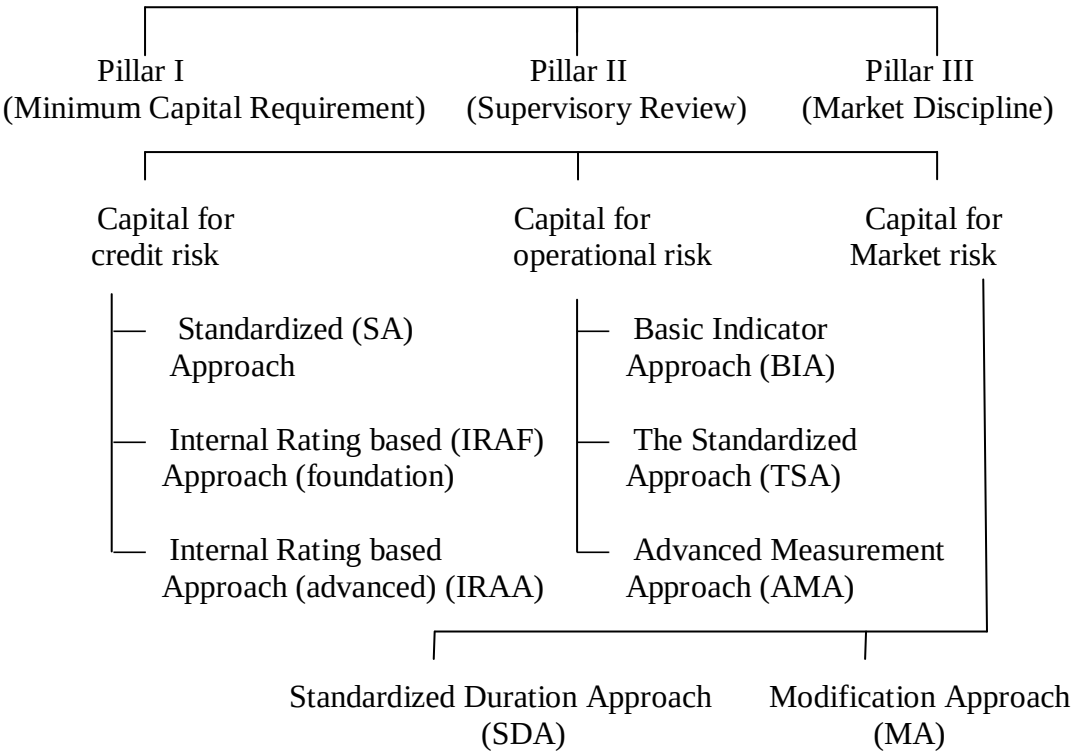
separately. Also it provides a range of options for determing the capital requirements for credit risk and operational risk. Banks are required to select approaches that are most appropriate for their operations and financial markets. The finalised Basel II Accord was released in June 2004. The mid term review of annual policy for the year 2006-07 from the Reserve Bank of India (RBI) revealed that the intended date for adoption of Basel II, i.e. March 2007, had to be postponed by two years, taking into consideration the stake of preparedness of the banking system in the country. This accord is based on three pillars, viz.

Pillar I: Minimum Capital Requirement

Pillar II: Supervisory Review

Pillar III: Market Discipline

Structure of Basel II Accord



Minimum Capital Requirement (Pillar I)

The Minimum Capital Requirement (MCR) is set by the capital ratio which is defined as (Total Capital - Tier I + Tier II + Tier III) / credit risk + market risk + operational risk). Basel I provided for only a credit risk charge. A market risk was implemented in 1996 amendments. In the initial stage, all banks are required to follow standardized approach in credit risk, basic indicator approach in operational risk and standardized duration approach in market risk. Migration to higher approaches will require RBI permission. Higher approaches are more risk sensitive and may reduce capital requirement for banks following sound risk management.

Supervisory Review Process (Pillar II)

The supervisory review process is required to ensure adequacy as well

as to ensure integrity by the risk management processes. The Basel Committee has started four key principles of supervisory review as under:

- Bank should have a process for accessing its overall capital adequacy in relation to its risk profile, as well as, a strategy for maintaining its capital levels.
- Supervisors expect banks to operate above the minimum regulatory capital ratios and ensure banks hold capital in excess of the minimum.
- Supervisory shall review bank, internal capital adequacy assessment and strategy, as well as compliance with regulatory capital ratios.
- Supervisors shall seek to intervene at an early stage to prevent capital from falling below prudent levels.

The Reserve Bank of India being the supervisor of the banking operation in India is expected to evaluate how well banks are assessing their capital needs relative to their risks. When deficiencies are identified, prompt and decisive actions are expected to be taken by the supervisors to reduce the risk.

Market Discipline (Pillar III)

Effective market discipline requires retable and timely information that enables counter parties to make well established risk assessment. Pillar III relates to periodical disclosures to regulator, Board of Bank and market about various parameters which indicates the risk profile of the bank. Reserve Bank of India has stipulated that banks should provide all Pillar III disclosures, both quantitative and qualitative as at the end March each year along with the annual financial statement. The banks are required to put such disclosures on its websites. Market discipline promotes safety and soundness in banks and financial system and facilitates banks conducting their business in a safe, sound and efficient manner.

Challenges in the Indian context

Basel II is intended to improve safely and soundness of the financial system by placing increased emphasis on bank's own internal control and risk management processes and models, the supervisory review process and market discipline. Indeed, to enable the calculation of capital requirements under the new accord requires a bank to implement a comprehensive risk management framework. However, these changes will also have wide ranging effects on bank's information technology systems, processes, people and business, beyond the regulatory compliance, risk management and finance functions. Though every bank has to invest lot of time, manpower and energy in the implementations of Basel II, yet it helps the banks to assess the risks associated with the business effectively. More so, it facilitates the banks to produce quantified and more realistic measure of the risk. Basel II enables the banks to handle business with more confidence and make better business decisions.

But the techniques and the methods suggested in the new accord would pose considerable implementation challenges for the banks especially in a developing country like India; some of them are described as under:

- Implementation of the new framework will require substantial resources and commitment on the part of both banks and supervisors. Banks are required to make

enormous improvements in the areas of policies, organisational structure, MIS, tools for analysis, process, specified training of staff etc. It will involve huge cost both for the banks as well as for supervisors.

- The new norms will increase the capital requirements in all the banks due to introduction in multiple risk weights with preferential treatment for high rated assets. Although the capital requirement for credit risk may go down due to adoption of more risk sensitive techniques such as securitization, derivatives, melting services, equity holdings, venture capital and guarantees etc.
- Risk management is extremely data-intensive. Accurate, reliable and timely availability of data is crucial for proper risk management. Banks need to implement substantial changes to their internal systems to prepare for appropriate data collection and revised reporting requirements. These changes may require systems integration, modification and introduction of new software. Banks need to assess the capabilities of their present systems and review the necessary system changes required.
- To provide the basis for forecasting and building of models in respect of various activities, such as loaning, security and foreign exchange transactions, a lot of historical data is required. In the Indian context major handicap is the absence of data series, particularly, related to the transactions in individual loan accounts.
- The new capital accord assigns risk-weight of sovereign at 0-50%. These 13 also a higher risk weight to the small and medium enterprises. In India, the PSBs have more than 40 percent of their lending to priority sector. The implementation of Basel II can adversely affect the priority sector lending.
- Even the G-10 countries are finding it difficult to implement the Basel II accord in all the banks. Therefore, longer time may be required for its implementation in some or all the banks in India.
- In India, credit rating is restricted to issues and not to the issuers. While Basel II gives some scope to extend the rating of issues to issuers. This would be an approximation and it would be necessary for the system to move to the rating of issuers. Encouraging rating of issuers would be a challenge.
- Yet another requirement for establishing risk management system is trained and skilled manpower. The managers should understand both the theory and practice of risk. To reach such on understanding undoubtedly involves a continuous learning process in the new technologies. Inducting a continuous learning process in the line managers and educating them in risk management is a task to be addressed on priority by the banks for the smooth adoption of the risk management principles and practices and Basel-II recommendations across the banks. Skill development for risk management approaches, both at the bank level and at supervisors' level, would be a tough task ahead.

Conclusion

Risk is an opportunity as well as a threat and has different meanings for different users. The banking industry is exposed to different risks such as forex volatility, risk, variable interest rate risk, market play risk, operational risks, credit risk etc. which can adversely affect its profitability and financial health. Risk management has thus emerged as a new and challenging area in banking. Basel II intended to improve safety and soundness of the financial system by placing increased emphasis on bank's own internal control and risk management process and models. The supervisory review and market discipline. Indeed, to enable the calculation of capital requirements under the new accord requires a bank to implement a comprehensive risk management framework. Over a period of time, the risk management improvements that are the intended result may be rewarded by lower capital requirements. However, these changes will also have wide-ranging effects on a bank's information technology systems, process, people and business, beyond and regulatory compliance, risk management and finance function.

The task of integrating Basel II is challenging. Indian banks have come a long way since independence and more so after LPG era, however, still they have to cover some distance so as to be bench marked with the best banks globally. But one thing is for sure that the reform process is on and the Indian banks are in the right direction. They have adopted best structures, processes and technologies available worldwide and have moved from strength to strength. Still the future poses various challenges for the banking industry.

References

Ahluwalia, M.S. 2001. Second Generation Reforms in Banks: Major Issues, Paper presented at the Bank Economists Conference, New Delhi, January.

Ahuja, K. 1997. The Banking Sector after the Reforms, *The Indian Economic Journal*, Vol. 4, No. 4, April-June, pp. 1-8.

Bakshi, Swapan R. 1998. Capital adequacy ratio-the banking benchmark. The Chartered Accountant. Vol. XLVI, No. 9, March, pp. 10-14.

Ballabh, J. 2001. The Indian Banking Industry: Challenges Ahead, *IBA Bulletin*, Vol. XXIII, No. 4 & 5, April, pp. 8-10.

Capital (in) adequacy in Indian Banks. PNB Monthly Review. Vol. 22, No. 9, September 2000, pp. 1-4.

Core principles for effective banking supervision-an assessment of the position in India. Reserve Bank of India Bulletin. December 1999. Vol. LIII, No. 12, pp. 1303-1324.

Das, A. 2002. Risk and Productivity change of Public Sector Banks, *EPW*, February, pp. 437-447.

Jalan, B. 2000. Agenda for Banking in the new Millennium, *RBI Bulletin*, March, pp. 253-257.

Jalan, B. 2002. Indian Banking and Finance: Managing New Challenges, Addressed delivered at the twenty third Bank Economist Conference at Kolkata, January.

Kaveri, V.S. 2001. Prevention of NPAs-Suggested, *IBA Bulletin*, Vol. XXIII, No. 8, August, pp. 7-9.

Manickavel S. 1996. Adequacy of capital and safety of banks. The Banker. May, pp. 24-25.

Prudential norms on capital adequacy, income recognition, asset classification, provisioning, etc. The Banker. April 2000, p. 11.

Radhakrishnan, R. 2000. Prompt corrective action. PNB Monthly Review. Vol. 22, No. 9, September, pp. 5-18.

Rao, Ramachandra, B. 1996. Qualitative credit deposit ratio versus capital adequacy ratio. The Banker. August, pp. 17-18.

RBI view on new capital adequacy framework. The Banker. April 2000, pp. 11-12.

Singh, Ranbir. 2003. Profitability Management in Banks Under Deregulated Environment, *IBA Bulletin*, Vol. XXV, No. 7, July, pp. 19-26.

Sivaprakasam, R. 1999. Norms for capital adequacy. The Journal of the Indian Institute of Bankers. Vol. 70, No. 4, October-December, pp. 26-34.

Talwar, S.P. 1999. Emerging trends in supervision. Reserve Bank of India Bulletin. Vol. LIII, No. 3, March, pp. 377-385.

Vashisht, A.K. 2004. Commercial Banking in the Globalized Environment, *Political Economy Journal of India*, Vol. 13, Issue 1 & 2, January-June, pp. 1-11.

Wahab, A. 2001. Commercial Banks Under Reforms: Performance and Issues, Edited Book, Deep & Deep Publications, New Delhi.

www.bankreport.rbi.org.in

www.rbi.org.inwww.report.rbi.org.in