



INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE AND MANAGEMENT

CONTENTS

Sr. No.	TITLE & NAME OF THE AUTHOR (S)	Page No.
1.	CUSTOMER SATISFACTION AND SUSTAINABLE FIRM PERFORMANCE: THE ROLE OF UNCERTAINTY DR. SANAL K. MAZVANCHERYL	1
2.	MOVEMENT FROM EEE SYSTEM TO EET SYSTEM DR. SAMBHAV GARG	7
3.	THE IMPACT OF CAPITAL STRUCTURE-CHOICE ON FIRM PERFORMANCE: EMPIRICAL INVESTIGATION OF LISTED COMPANIES IN COLOMBO STOCK EXCHANGE, SRILANKA B. PRAHALATHAN & DR. (MRS.) R.P.C.RANJANI	12
4.	AN ANALYSIS OF ORGANISATIONAL CULTURE IN THE COMPANIES DR. ARAVIND. S., DR. FISSEHA GIRMAY TESSEMA & DR. HAILAY GEBRETINSAE	17
5.	RESOLVING EXPECTATIONS GAPS IN FINANCIAL REPORTING: ISSUES FOR INTERNATIONAL FINANCIAL REPORTING STANDARDS DR. JOHN A. ENAHORO	25
6.	E-BANKING SCENARIO AND ITS IMPACT ON CUSTOMERS' SATISFACTION IN INDIA PROF. (DR.) SULTAN SINGH & SAHILA CHAUDHRY	29
7.	A COMPREHENSIVE FINANCIAL ANALYSIS OF AQUA CULTURE FEED INDUSTRIES IN SOUTH INDIA ASLAM CHINARONG, PROF. (DR.) K. MARAN & DR B. YAMUNA KRISHNA	35
8.	A STUDY ON COUSTOMER SATISFACTION TOWARDS RELIANCE TELICOM IN TAMILNADU WITH SPECIAL REFERENCE TO SALEM CITY MR. B. ADHINARAYANAN & DR. K. BALANAGA GURUNATHAN	39
9.	VALUE FOR THE MONEY - SUCCESS MANTRA FOR MARKETERS IN RURAL MARKET DR. N. RAJASEKAR & R.PRIYA	44
10.	INDIGENOUS BRANDING – INDIA'S FUTURE BRAND STRATEGY (AN EMPIRICAL STUDY OF THREE DECADES OF BRAND WARFARE IN INDIA) DR. S. P. RATH, PROF. BISWAJIT DAS & PROF. CHEF GERARD D' SOUZA	49
11.	STOCK PRICE REACTION OF THE MERGED BANKS – AN EVENT STUDY APPROACH DR. P. NATARAJAN & K. KALAICHELVAN	54
12.	A STUDY ON ABSENTEEISM OF EMPLOYEES IN RETAILING INDUSTRY DR. N. SANTHI, MRS. D. MARIA ANGELIN JAYANTHI & MS. HEMALATHA	61
13.	MEASURING OF QUALITY OF WORK LIFE IN TEXTILE INDUSTRIES - AN INTEGRATION OF CONCEPTUAL RELATIONSHIP WITH PRODUCTIVITY N. MOHAN & DR. J. ASHOK	67
14.	RISK MANAGEMENT STRATEGIES AND PRACTICES IN THE BANKING SECTOR: CHALLENGES ARISING FROM GLOBAL RECESSION – KEY TO SURVIVAL & GROWTH K. BHAVANA RAJ & DR. SINDHU	71
15.	PREVENTIVE MEDICINE TO COMBAT OCCUPATIONAL STRESS OF EMPLOYEES IN BPO ORGANISATIONS – INDIA'S NEED OF THE HOUR DR. R. SRINIVASAN & MRS. A. BHARATHY	74
16.	AYURVEDIC WELLNESS TOURISM IN KERALA: A GATE WAY FOR ENTREPRENEURS TO EMERGE SUCCESSFUL RAMESH U & KURIAN JOSEPH	80
17.	THE BANNED SURROGATE MARKETING AS BRAND - NEW BRAND EXTENSION ADVERTISING V V DEVI PRASAD KOTNI	85
18.	COMPARATIVE STUDY ON RETAIL SHRINKAGE OF INDIA, ASIA-PACIFIC AND GLOBAL COUNTRIES SANDEEP RAJENDRA SAHU	90
19.	QUALITY OF WORK LIFE (QWL) FOR FINANCE PROFESSIONALS IN DUBAI DR. SANGEETHA VINOD, FAYAZ AHAMED M.A. & N. MOHAMED RAFIQ	96
20.	ART OF DELIGATION- A POWERFUL TOOL FOR LIBRARIAN NARENDER KUMAR, ASHISH SIWACH & MRS. SUNITA BHARATWAL	102
21.	A STUDY ON BENEFITS AND RISK ANALYSIS OF FUTURES AND OPTIONS IN MADURAI MS. K. HEMA MALINI & ER. R. DEEPA	105
22.	GREEN AND SUSTAINABLE MANAGEMENT – A DECIDING FACTOR FOR TOMORROW'S BUSINESS HARDEEP SINGH & BIKRAM PAL SINGH	110
23.	CHANGING CONDITIONS OF WORKERS AND PROCESSES OF WORK IN ADVERTISING AGENCIES IN INDIA DR. YASHMIN SOFAT	115
24.	INDIAN FINANCIAL SECTOR REFORM (1991-2001): MISSING A MANDATORY SOCIAL CONSENSUS SANJAY BHATTACHARYA	123
25.	A STUDY ON CONSUMER BEHAVIOUR IN SELECTING CREDIT CARDS DR. A. VALARMATHI & MRS. PRIYA KALYANASUNDARAM	127
	REQUEST FOR FEEDBACK	133

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RISK MANAGEMENT STRATEGIES AND PRACTICES IN THE BANKING SECTOR: CHALLENGES ARISING FROM GLOBAL RECESSION –KEY TO SURVIVAL & GROWTH

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ABSTRACT

Risk management is a cornerstone of prudent banking practice. Undoubtedly all banks in the present-day volatile environment are facing a large number of risks such as credit risk, liquidity risk, foreign exchange risk, market risk and interest rate risk, among others risks which may threaten a bank's survival and success. In other words, banking is a business of risk. For this reason, efficient risk management is absolutely required. Carey (2001) indicates in this regard that risk management is more important in the financial sector than in other parts of the economy. The purpose of financial institutions is to maximize revenues and offer the most value to shareholders by offering a variety of financial services, and especially by administering risks. Rudra Sensarma and M. Jayadev (2009) observed that modern financial institutions are in the risk management business as they undertake the functions of bearing and managing risks on behalf of their customers through the pooling of risks and the sale of their services as risk specialists. Thus, effective risk management either in non-banking firms or in banking entities is expected to enhance the value of the firm and shareholder wealth. This article throws a light on how Indian Banks could effectively manage risk during this global economic downturn or recession by implementing risk management strategies and practices, when global banks are collapsing and also suggests measures how global banks can learn from Indian Banks experience?.

KEYWORDS

Risk, Banking, Challenges, Recession, Survival.

INTRODUCTION

There was, first, the stockmarket crash of 1987; then the collapse of the exchange-rate mechanism in 1992-1993; the bond-market crash in 1994; the Mexican crisis later that year; East Asia's turmoil in 1997; Russia's default and the near-meltdown in the capital markets in 1998; and, most recently, the virtual collapse of the junk-bond market and presently sub prime crisis and bankruptcy of Lehman Brothers (2008-09 – Cont.). (Richard Cookson, 2009) Lehman Brothers went bankrupt September 15. A day earlier, Merrill Lynch had announced that Bank of America was acquiring it. A week earlier, US mortgage giants Freddie Mac and Fannie Mae went into federal receivership. (Prasanto K Roy, 2009)

The current global financial crisis signifies the importance of risk management in financial institutions and urged on the banks to follow risk management fundamentals in letter and spirit.

Risk is the fundamental element that drives financial behavior. Without risk, the financial system would be vastly simplified. However, risk is omnipresent in the real world. Financial Institutions, therefore, should manage the risk efficiently to survive in this highly uncertain world. The future of banking will undoubtedly rest on risk management dynamics. Only those banks that have efficient risk management system will survive in the market in the long run. The effective management of credit risk is a critical component of comprehensive risk management essential for long-term success of a banking institution.

The present turmoil in the financial sector provides an opportunity to learn from the financial worlds mistakes. This gives us the opportunity to look back and see what went wrong and structure our own financial houses so that this does not happen to us, or so severely affect the world again and the most significant lesson that has been learnt from recent events is the importance of fundamentals in risk management. For instance there is a basic rule since inception of banks which says do not put all your eggs in one basket.

If this simple rule is followed, many institutions could have avoided huge losses. Some fundamental principles form the cornerstone of risk management and if these principles are followed in letter and spirit financial institutions can be shielded from significant losses. These rules are simple and equally applicable on small institutions but simple means these are simple to understand; nevertheless implementing some of these fundamentals can be quite difficult.

Risk management is a cornerstone of prudent banking practice. Undoubtedly all banks in the present-day volatile environment are facing a large number of risks such as credit risk, liquidity risk, foreign exchange risk, market risk and interest rate risk, among others risks which may threaten a bank's survival and success. In other words, banking is a business of risk. For this reason, efficient risk management is absolutely required.

NEED FOR RISK MANAGEMENT IN BANKING SECTOR

- The current global financial crisis signifies the importance of risk management in financial institutions
- The raising complexities of banking management, the need to protect customer confidence, the greater weight of laws and codes of conduct over time are the most important causes of an increasingly high vulnerability of banks to non-traditional risks.
- According to Pagano (2001), risk management is an important function of financial institutions in creating value for shareholders and customers. The corporate finance literature has linked the importance of risk management with the shareholder value maximization hypothesis. This suggests that a firm will engage in risk management policies if it enhances shareholder value (Ali and Luft, 2002).
- Given the importance of risk management in a bank's functioning, the efficiency of a bank's risk management is expected to significantly influence its financial performance (Harker and Satvros, 1998). An extensive body of banking literature (Santomero and Babbel, 1997) argues that risk management matters for financial performance of banking firms.

OBJECTIVES OF THE STUDY

- To study the current risk management strategies and practices in the Indian Banking Sector.
- To study how Indian banks are managing risk during global recession.

- To suggest measures how global banks can learn from Indian banks with respect to risk management strategies and practices during global recession.

RISK MANAGEMENT IN THE INDIAN BANKING SECTOR

Risk management in Indian banking is driven by the central bank viz. the Reserve Bank of India (RBI)'s guidelines as well as banks' own recent initiatives towards risk management (RBI, 2007). This recent emphasis can be attributed to several reasons. Prior to 1992, Indian banks were subject to a regime of strict control enforced by the RBI.

A process of financial liberalization was initiated in 1992 to make the banking system profitable, efficient, and resilient. The liberalization measures consisted of deregulation of entry, interest rates, and branch licensing, as well as encouragement to state owned banks to get listed on stock exchanges. While banks took some time to adjust to the new operating environment, the year 1998 saw a second phase of reforms in the banking industry marked by the introduction of several prudential measures and the first set of comprehensive guidelines for Asset-Liability management and risk management.

Thus, the period after 1998 in Indian banking offers a suitable set-up for an analysis of risk management and its impact on banks' stock returns. During this period, the RBI also issued a comprehensive framework for implementation of integrative risk management systems and lately Indian banks have been preparing for the implementation of Basel-II norms, which includes a move towards better risk management practices.

PROCESS STEPS OF RISK MANAGEMENT

The following steps of the risk management process, which are based on those originally detailed in the Australian / New Zealand standard in Risk Management (AS / NZS 4360), describe seven iterative elements



THE ECONOMIC DOWNTURN AND INDIA

India is not de-linked from the world, and the financial meltdown has certainly impacted us. In the age of globalization, no country can remain isolated from the fluctuations of world economy. Heavy losses suffered by major International Banks is going to affect all countries of the world as these financial institutes have their investment interest in almost all countries.

The extent of impact has been restricted due to several reasons such as-

- Indian financial sector particularly our banks have no direct exposure to tainted assets and its off-balance sheet activities have been limited. The credit derivatives market is in an embryonic stage and there are restrictions on investments by residents in such products issued abroad.
- India's growth process has been largely domestic demand driven and its reliance on foreign savings has remained around 1.5 per cent in recent period.
- India's comfortable foreign exchange reserves provide confidence in our ability to manage our balance of payments notwithstanding lower export demand and dampened capital flows.

However, one positive point in favor of India is the fact that Indian Banks are more or less secured from the ill-effects of sub-prime mess.

ROLE OF RBI WITH RESPECT TO RISK MANAGEMENT

Executive Director of one of Indian's biggest public-sector banks, Bank of Baroda, RK Bakshi, says: "Due credit should be given to the Reserve Bank of India (RBI). Being the apex bank of the country, it managed the monetary policies quite efficiently. When inflation was on the rise, RBI strengthened its hold over the markets and increased interest rates. But immediately after the fall of Lehman Brothers, RBI reduced the interest rates to increase liquidity in the markets. RBI also ensured that inter-bank transactions were not affected during this economic crunch, which in effect led to smooth payments and money transfers."

There has been a sustained demand from various quarters for exercising regulatory forbearance in regard to extant prudential regulations applicable to the banking sector. As a part of counter-cyclical package, RBI has already made several changes to the current prudential norms for robust risk disclosures, transparency in restructured products and standard assets such as- (Nidhi Choudhari, 2009)

- Implementation of Basel II w.e.f. March 2009 by all Scheduled Commercial Banks except RRBs which would promote closer cooperation, information sharing and coordination of policies among sector wise regulators, especially in the context of financial conglomerates.
- Further guidance to strengthen disclosure requirements under Pillar 3 of Basel II.
- Counter-cyclical adjustment of provisioning norms for all types of standard assets (except in case of direct advances to agriculture and small and medium enterprises which continue to be at 0.25 per cent).

STRATEGIES ADOPTED BY INDIAN BANKS TO AVERT RISK

Measures the risk management function should take to manage risk in financial institutions.

1. A Risk Analysis Team is to have impartial and unbiased assessment of risk with no favoritism towards any business unit and its unbiased dissemination to the senior management and board. Obviously this can be accomplished only if the function is independent of risk units of the organization and which reports directly to the CEO regularly and the Board periodically.
2. The independent Risk Analysis Team can only be effective if they have influence in day to day operations of the institutions. In this regard, the support of the Board and CEO is a prerequisite. Two things will be suggested, firstly the stature of Chief Risk Officer (CRO) should be equivalent to the other business units and secondly there should be frequent dialogues between the CRO and senior management (CEO & Heads of various business units).
3. It is important to have an independent Risk Analysis Team; one cannot absolve the business units of their responsibility in relation to risk management. Risk Management can be durable if it is entwined in the overall culture of the organization. People who are taking risks must know the risks and rewards associated with the transactions they are undertaking and the risk appetite as well as the tolerance limits.
4. Therefore the risk managers in each business unit must understand how their independent risk management within their division integrates within the entire organization. Similarly, an important element of risk management is the establishment of risk discipline and oversight to insure that additions to or changes in the asset liability mix are consistent with the overall plan.
5. A reliable and respected information system is the foundation of risk identification and measurement. Timely availability of accurate information is essential to have meaningful assessment of risk. Many Indian banks realized its importance and invested significant resources in improving their IT systems. Accurate information and frequent dialogue with business units, institutions should take into account a few other things while designing and implementing risk measurement systems.
6. The risk measures adopted should encompass the whole organization. Risk identified in silos may undermine the enterprise wide risk the overall institution is facing. Similarly banks can use multiple techniques for assessment of risk factors which will add additional dimension and depth when viewing risk from different perspectives and in different economic environments. The banks should also use qualitative analysis in addition to quantitative risk measures. In effect the predictability of quantitative outcomes is highly dependent on the qualitative nature of the assets, and similar stability of liability accounts.

7. Risk measurement should be augmented by analyzing the banks position under extreme but plausible scenarios. Stress testing has gained further significance in the aftermath of the recent financial turmoil. It is noted that stress scenarios in the past cannot always be indicative of future events, meaning that banks should be somewhat creative in designing potential shocks.
8. Risk management begins with developing a culture to address business risks. The monitoring role that board members must play is vital to the success of risk management in any Bank.
9. Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II is likely to lead to an even closer focus on risk measurement and risk management at the institutional level. Thankfully, Basel II has, through their various publications, provided useful guidelines on managing the various facets of risk. The institution of sound risk management practices would be an important pillar for remaining ahead of the increasing competition. Banks can, on their part, formulate 'early warning indicators' suited to their own requirements, business profile and risk appetite in order to better monitor and manage risks. (Dr. Y.Venugopal Reddy, 2004)

TALKING ABOUT THE KEY PRINCIPLE OF GOVERNANCE

A sturdy risk management framework in any institution cannot be established unless it is given due recognition by its board and senior management. Risk Management is not just a regulatory compliance issue; it is the apparatus that will help you deal with the peril on your way towards achieving organizational objectives.

RBI Governor, Subbarao: Reserve Bank's policy response was aimed at containing the contagion from the global financial crisis while maintaining comfortable domestic and foreign exchange liquidity. (Dr. D. Subbarao, 2009)

STATE OF GLOBAL BANKS DURING ECONOMIC DOWNTURN

"Multinational banks in India are going through a very difficult period," says Viren H. Mehta, director of Ernst & Young India. "While they are well capitalized in India (from an Indian balance sheet perspective), they are highly dependent on their head offices. If the parents don't survive, they will not be able to survive here." Adds Robin Roy, associate director at international professional services firm PricewaterhouseCoopers (PwC): "Hit by global contagion, ransacked by investors, and almost deserted by many customer profiles, foreign banks need to consolidate and get their act together."

(Knowledge@Wharton, 2009)

"The fall of Lehman Brothers and the ensuing institutional uncertainty saw massive withdrawals from foreign banks and an increase in deposits with PSU (public-sector undertaking) banks, particularly SBI, as it was assumed that the government would always bail them out," says Chakrabarti. Notes Paresh Sukthankar, Executive Director of the private-sector HDFC Bank, which has weathered the storm: "People see PSU banks as government-owned. They feel the government will stand by them in case they are in trouble."

MEASURES HOW GLOBAL BANKS CAN LEARN FROM INDIAN BANKS WITH RESPECT TO RISK MANAGEMENT STRATEGIES AND PRACTICES DURING GLOBAL RECESSION

1. "Best practices" and state-of-the-art risk management models adopted by Indian banks. Foreign banks should emulate these models.
2. Transparency, robust risk management, optimum internal controls and reliable risk management practices by Indian Banks.
3. To bring market risks under effective control and ensure their healthy and steady development, foreign players should perfect their risk control measures and gradually localize their risk management functions.
4. "Foreign banks should establish independent and effective risk control departments with sufficient and competent risk-control personnel supervising their RMB operations.
5. Foreign lenders are required to evaluate their risk exposure and profits and losses more accurately, providing reliable information and data for authorities to better control market risks.

CONCLUSIONS

To conclude the crisis is forcing countries around the world to test the limits of their fiscal and monetary tools. This is true for macroeconomic policy. Our economy remains fundamentally strong despite the adverse impact of the global financial crisis. With the right mix of macroeconomic policy and corporate strategy, as an economy, we will emerge from this global recession stronger than before. Banks must consider how procedures may be improved in order to reduce risk. There are pressing immediate reasons why banks should be reconsidering their risk management strategies. It is sensible to adopt a systematic approach to risk management by banks. Indian banks are efficient in managing risk, risk identification and risk assessment by averting any unexpected risk through risk management practices when compared to foreign banks

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Hoping an appropriate consideration.

With sincere regards

Thanking you profoundly

Academically yours

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