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THE CHANGING FACE OF RISK MANAGEMENT IN INDIAN COMMERCIAL BANKS

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ABSTRACT

Banking is an important segment of the tertiary sector and acts as a backbone of economic process .A bank is a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly or through capital markets. A bank connects customers with capital deficits to customers with capital surpluses. Banks face a number of risks in order to conduct their business that must be managed carefully, especially since a bank uses a large amount of leverage. Without effective management of its risks, it could very easily become insolvent. Banking is generally a highly regulated industry and restrictions on financial activities by banks have varied over time and location. The current set of global bank capital standards is called Basel-II. This paper briefly describes main risks face by banks, risk management, deposit, economy and about banking industry.

KEYWORDS
types of risks, risk management, deposits, economy, banking industry.

1. INTRODUCTION

The commercial banks play an important role in the process of economic development of a country. They are the major source of mobilizing savings in an economy. They also help in accelerating the rate of capital formation. Bank face a number of risks in order to conduct their business and how well these risks are managed and understood is a key driver behind profitability and how much capital a bank is required to hold. Some of the main risks face by banks includes:

Type of Risk		Possible Risk Events
External Risk	Environment	Compliance, Contamination, employment theft and public health
	Country	Civil disorders, economic shock, expropriation, natural disaster
	Fiscal	Change of Government, corporate/sales tax rate changes
	Government	Consumer demand, effect of Government change, inflation, anti-business ethos
	Litigation	Product liability, safety, side effects
	Regulatory	Capital adequacy, competition policy, tariff barriers, trade policy
	Security	Intellectual property theft, sabotage, physical property theft
Fund Management Risk	Dealing	Market information, inappropriate internal information, market collapse, personnel, rogue dealing
	Processing	Collusion, dealing error, fraud, input/output error,
	Statutory	Financial regulation, legal issues, taxation treaties
	Trading	Documentation, execution accuracy, settlement, valuation methodology
Infrastructure Risk	Human resource	Lack of staff, quality of staff, strike action, lack of training, succession planning
	Organizational	Objectives, policies, alliances, market image, authority limits, audit, sales force profile
	Planning	Accuracy of situation appraisal, incorrect budgeting, poor quality of data, forecasting inaccuracies
	Reporting	Accounting policies, data flow, complex management policy
	Systems	Inadequate performance, alignment to business strategy, availability of systems, data integrity, disaster planning, programming quality, network security, telecommunication, verified algorithms
Liquidity Risk	Cash flow	Business interruption, customer confidence, forecasting quality, access to finance
	Counter party	Default(credit) risk, financial performance of counter party, credit rating, bank confidence liquidity, supplier confidence
	Rating	Market confidence, market sector, re-rating, shareholder risk
Operational Risk	Logistics	Delivery mechanism, global distribution, handling of shortages
	Procurement	Alternative source identification, quality of parts, stock exchanges, supplier profile
	Production	Cost, make versus buy, process problem, quality reviews, technology
Position(Market) Risk	Currency	Non-convertibility of currency, economic factors, transaction risk, translation risk, mismatches, volatility
	Interest Rate	Basis risk, parallel yield curve shifts, twists in yield curve, incorrect day count basis
Proposition Risk	Competitive	Competitor product action, inferior product, product imitation, patent expiry
	Economic	Client pricing, competitor pricing, market share, market developments, product expiry
	Strategy	Business portfolio, communication, development methodology, efficiency, human resource profile, initial pricing, lack of competitor knowledge, poor market identification, poor market strategy, reputation, research focus, tracking against plan

2. LITERATURE REVIEW

Within the last few years, a number of studies have provided the discipline into the practice of risk management within the corporate and banking sector. An insight of related studies is as follows:

Amran, *et al*. (2009), explored the availability of risk disclosures in the annual reports of Malaysian companies. The study was aimed to empirically test the characteristics of the sampled companies. The level of risk faced by these companies with the disclosure made was also assessed and compared. The findings of

the research revealed that the strategic risk came on the top, followed by the operations and empowerment risks being disclosed by the selected companies. The regression analysis proved significantly that size of the companies did matter. The stakeholder theory explains well this finding by stating that "As company grows bigger, it will have a large pool of stakeholders, who would be interested in knowing the affairs of the company." The extent of risk disclosure was also found to be influenced by the nature of industry. As explored within this study, infrastructure and technology industries influenced the companies to have more risk information disclosed.

Hassan, A. (2009), made a study "Risk Management Practices of Islamic Banks of Brunei Darussalam" to assess the degree to which the Islamic banks in Brunei Darussalam implemented risk management practices and carried them out thoroughly by using different techniques to deal with various kinds of risks. The results of the study showed that, like the conventional banking system, Islamic banking was also subjected to a variety of risks due to the unique range of offered products in addition to conventional products. The results showed that there was a remarkable understanding of risk and risk management by the staff working in the Islamic Banks of Brunei Darussalam, which showed their ability to pave their way towards successful risk management. The major risks that were faced by these banks were Foreign exchange risk, credit risk and operating risk. A regression model was used to elaborate the results which showed that Risk Identification, and Risk Assessment and Analysis were the most influencing variables and the Islamic banks in Brunei needed to give more attention to those variables to make their Risk Management Practices more effective by understanding the true application of Basel-II Accord to improve the efficiency of Islamic Bank's risk management systems.

Al-Tamimi (2008) studied the relationship among the readiness of implementing Basel II Accord and resources needed for its implementation in UAE banks. Results of the research revealed that the banks in UAE were aware of the benefits, impact and challenges associated in the implementation of Basel II Accord. However, the research did not confirm any positive relationship between UAE banks readiness for the implementation of Basel II and impact of the implementation. The relationship between readiness and anticipated cost of implementation was also not confirmed. No significant difference was found in the level of Basel II Accord's preparation between the UAE national and foreign banks. It was concluded that there was a significant difference in the level of the UAE banks Basel II based on employees education level. The results supported the importance of education level needed for the implementation of Basel II Accord.

Al-Tamimi and Al- Mazrooei (2007) provided a comparative study of Bank's Risk Management of UAE National and Foreign Banks. This research helped them to find that the three most important types of risks facing the UAE commercial banks were foreign exchange risk, followed by credit risk and then operating risk. They found that the UAE banks were somewhat efficient in managing risk; however the variables such as risk identification, assessment and analysis proved to be more influencing in risk management process. Finally, the results indicated that there was a significant difference between the UAE National and Foreign banks in practicing risk assessment and analysis, and in risk monitoring and controlling.

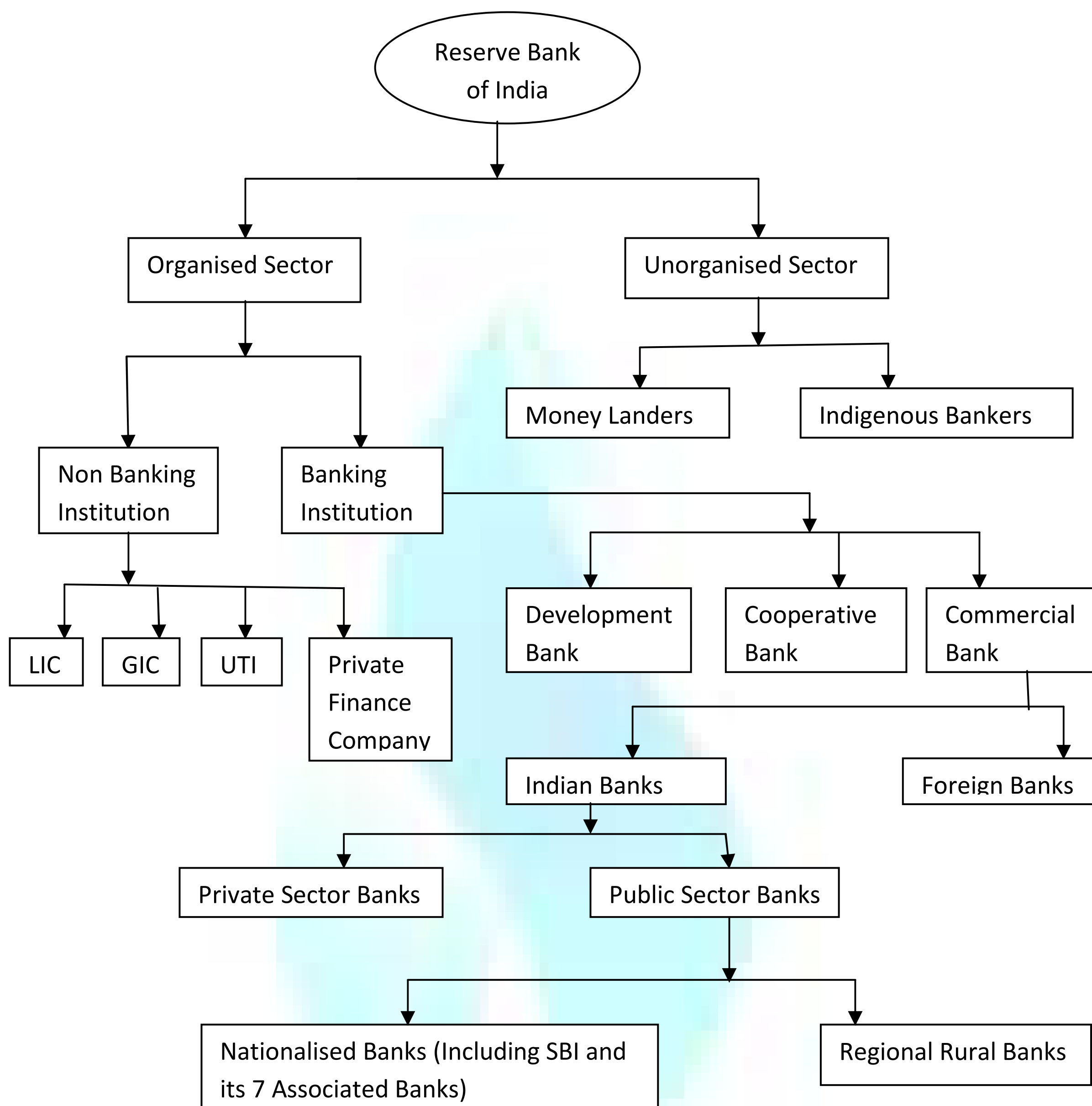
Koziol and Lawrenz (2008) provided a study in which they assessed the risk of bank failures. They said that assessing the risk related to bank failures is the paramount concern of bank regulations. They argued that in order to assess the default risk of a bank, it is important considering its financing decisions as an endogenous dynamic process. The research study provided a continuous-time model, where banks chose the deposit volume in order to trade off the benefits of earning deposit premiums against the costs that would occur at future capital structure adjustments. Major findings suggested that the dynamic endogenous financing decision introduced an important self-regulation mechanism.

3. GENESIS OF BANKING IN INDIA

Banking in India is as old as ancient Vedic period. However, the English Agency House established the first modern bank known as "The Bank of Hindustan" at Calcutta in 1770. After that Bengal Bank was setup in 1784 and around 1786 "General Bank of India" was established, but these banks could not provide the services due to their own crises.

The Reserve Bank of India was established in 1935. The State Bank of India was established on April 01, 1935 and acted as a Bankers Bank and an agent of the government. India's present financial system is large with a variety of banks, financial institutions, capital market institutions, non banking institutions and a number of indigenous banks. Among the financial institutions in India, banks are the prominent financial intermediaries and in fact financial inter-mediation is largely synonymous with banking. Banking operation in India are the controlled by the Reserve Bank of India. The structure of Indian system is depicted in the flow chart given below:

CHART 1



4.IMPACT OF REFORMS ON INDIAN BANKING SECTOR

The process of liberalisation, globalisation and opening up the contours of national economies began in the early nineties in many countries including India. Major changes in the policies, reversing the past over four decades of regulation took place during the nineties. The Government took a number of initiatives to open up the economy. Broadly, the initiatives include the following:

- Driven by commitments under WTO, the first initiative was the lowering of tariff and non-tariff trade barriers. Thereby, protection given to industrial and other sectors was practically removed. This was accompanied by de-listing of items reserved for manufacture by small scale industrial units, reducing to the controls on items of import, reduction in duties on incoming consumer goods, etc.
- Earlier, the entry and exit of business entities/groups in a particular sector or a threshold was controlled by the government, at times both at the central and state levels. Such controls were implemented through licensing or/and other approval procedures that were time consuming and industrial units faced many problems. As a liberalisation measure, industrial licensing was abandoned in many sectors.
- Foreign capital for indigenous units was not , previously acceptable to the policy makers. Inviting foreign capital/equity was therefore consciously discouraged. This was more evident in the case of public sector units. With reforms, government reversed the erstwhile policy and permitted inflow of foreign/private capital in many areas previously reserved for the public sector.
- The case of foreign direct investments was similar to the foreign capital. The then rules and regulations discouraged the inflow of such funds , in the case of foreign entities in banking business, where the licensing policy was restrictive. Restrictions on foreign direct investment as also entities were more or less were removed as a globalization measure.
- Privatisation of public sector units either through strategic or general public participation in ownership is one of the reform oriented measures adopted in the nineties. The progress in this regard in the early part of the decade was slow. This process has been now speeded up notwithstanding the opposition to such a measure from within the ruling coalition or outside. Food subsidies have been reduced.
- On the external front, the fillip to exports had been the major priority. Towards this end in addition to fiscal incentives to export promotion, the last decade has also witnessed some devaluation of the rupee. The external value of rupee has been rationalized to reflect its inherent purchasing power in external terms.

Banking industry has been, all along responding to such changes. Banks have taken steps to change their policies and processes to ensure that they remain strong and manage the reform related changes effectively. It must be recognised that the thrust placed by banks on issues like risk management, asset/liability management, technological advancement etc is necessary for a strong, viable and profitable existence. In case, banks do not change, there is a possibility of getting marginalized by the new competitors.

Risk taking is inherent to banking business. Banks engage themselves in the process of financial intermediation by taking risks to earn more than what they pay to the depositors. Each bank as well as every banker needs to understand and appreciate that risk is unavoidable. The existence and quantum of risk associated with each transaction cannot be ascertained with certainty. Whatever models that have been developed for risk management, are primarily on the basis of observed occurrences of the past, which may or may not be repeated in future. Risk is inherent to business. Since it cannot be eliminated, it has to be managed.

5.CHANGING FORMS OF RISK

Risk is associated with every business activity. It is more prominent and pronounced in respect of financial sector in general and banks in particular. In a repressed financial system risk is not apparent. Risk management in such a situation may not be well organised. With deregulation, the unorganised efforts towards risk management have now been substituted by systematic and formal policy endeavours. New concepts like 'anticipate/prevent/monitor mitigate' have substituted the earlier ethos of 'inspect/detect/react'. The emphasis is now more on processes and not on people alone. The changed scenario for risk management has thrown up many challenges for banks. Banks are advantageously placed as they deal with a large volume of public funds. As they are accountable for the same and for performing effectively and objectively, the bank management needs a strong MIS (Management Information System)/DSS (Decision Support System) on an online real time basis.

6.COMMITTEES DEDICATED TO RISK MANAGEMENT DEPARTMENT

Committees who are responsible for supervising the risk management activities of the bank are the following:

- **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.

7. CONCLUSION

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 management from time to time.

Bank carried out a comprehensive Self-Assessment exercise spanning all the risk areas and evolved a road map to move towards implementation of Basel-II as per RBI'S directions The program in implementation of Risk Management, Organisational Structure, Risk measures, risk data compilation and reporting etc. is as per this laid down road map.

The Policies framed and procedures/practices adopted are benchmarked to the best in the industry on a continuous basis and the Bank has a clear intent to reach an advanced level of sophistication in management of risks in the coming year. The ever-improving risk management practices in the Bank will result in Bank emerging stronger, which in turn would confer competitive advantage in the Market.

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