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## A STUDY ON THE RISK CULTURE IN BANKING SECTOR

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### ABSTRACT

*Risk culture has been a crucial agenda in banking sector. It is a fundamental technique to manage risks in banking sector. Risk culture include: Behavior and attitudes practiced banks in daily operations, good understanding of risk concepts, training programs, communication system, banks governance which increases competence in employee's job performance. The concept of risk culture has grown significantly since the global financial crisis of 2008s. Culture has a key role to play in causing the crisis and that culture change, whatever this might be, is necessary to restore trust and to ensure that a similar crisis can never happen again. The study was done in commercial banks available in Karnataka state. The aim of the paper is to explore characteristics of banks in Karnataka towards risk culture. It was found that banks in Karnataka state have less implemented risk culture. The paper has suggested measures to be taken by bank officers, policy makers, and stakeholders to execute risk culture which is the Centre for effective risk management. The findings of the study support in facilitating effective decisions regarding risk matters in the bank sector.*

### KEYWORDS

bank sector, financial institutions, global crisis, risk culture.

### INTRODUCTION

The wide scope and effectiveness of risk culture is a principal pillar of the banking efforts to reduce the severity and mitigate risks posed by financial sector. An acceptable and effective approach to practice risk culture is based, among other things, on well understanding of the occurrence and management of risk, ability to engage in high-level responsibility of the board of directors and top management on the banking sector and to establish risk appetite framework. Risk culture is a complex concept which involves behaviors and attitudes. In the process of risk culture Boards are focusing on the bank's norms, attitudes and behaviors related to risk awareness, risk taking and risk management. Mis-implementing risk culture are often considered a root cause of the global financial crisis. The bank's risk culture plays an important role in shaping the behavior of employees within the banks and in controlling the bank's external environment. During and post-global financial crisis of 2008s showed the failures of specific banks and other financial institutions, in the light of events such as payment protection insurance mis-selling, rogue trading. Ashby (2011), have highlighted a range of micro-level cultural 'weaknesses' within specific financial organizations. Influential associations such as the Institute of International Finance (IIF) have even gone as far as to state that the: "...development of a 'risk culture' throughout the firm is perhaps the most fundamental tool for effective risk management." (IIF, 2008)

The concept of risk culture, coupled with a growing acceptance of the fact that there is a relationship between the cultures of financial institutions and their risk management decisions. This paper answers the question as to how do the risk culture of the bank should be well understood and leads to efficiency of the sector.

### LITERATURE REVIEW

The field of risk culture has been crucial in the banking sector, bank experts, academicians; financial analysts have come up with different ideas on how to strengthen risk culture as a core solution of risks in the banks. State Street, (2012) on the study with asset managers and owners, 78% of the respondents have said that their institution has understood risk culture practices and 30% of the investment institutions made this their concern in 2007. During the period of the 4 to 5 years after the crisis, it is shown that institutions are taking initiatives to build risk cultures among their employees. Ernst & Young, (2012) have discussed risk culture by top management among the institutions that have been affected by the financial crisis. 39% of the respondents have said that risk culture has been the center of focus since 2008 financial crisis. Financial institutions have put emphasis on the awareness of risk culture. Watson, T (2012), concluded that, Regulations have placed higher emphasis for financial institutions to prove their effectiveness in risk management culture. Rating agencies consider a company's risk culture as an asset to its value; improvements are required by financial institutions to meet these expectations. However, an organization can only effectively improve its risk culture if they are aware of their current culture. Ernst & Young survey, (2008) during the first phase of the financial crisis with 36 banks worldwide, 73% of respondents agreed the necessity of establishing and developing a risk culture. Risk should start from the top to bottom. The effectiveness of risk culture throughout the bank and making sure that it is understood at every level from risk management organization to front line is crucial.

The discussion above shows the current significance of bringing the concept of risk culture into well understanding by discussing empirically variables which form risk culture.

### STATEMENT OF THE PROBLEM

With the opening of the Indian financial sector, banks have been facing financial and non-financial risk. The Reserve Bank of India together with Bank of International Settlements (BIS) have been in front line to provide regulations to build strong risk culture in banking system. Risk continue to be the central issue in management of banks. The paper creates the root solution by analyzing risk culture.

### OBJECTIVES OF THE STUDY

1. To study banking operating environment
2. To know risk management practices in banks
3. To explore challenges facing banks in implementing risk management

### RESEARCH METHODOLOGY

A survey was conducted using structured questionnaire to seek the opinions of commercial banks' officers on the banks' risk in Karnataka state. A total of thirty (150) questionnaires were circulated to bank officers of 15 randomly selected Public and Private commercial Banks. The survey was done over a period of four



months i.e. from February to June, 2015. Additionally, this study appraises the management of risk culture in commercial banks using the Likert-type scale that ranges from 1 to 5 with the following equivalences, "-2": "strongly disagree"; "-1": "disagree"; "1": "agree to disagree"; "2": "agree"; and "3": "strongly agree".

## FINDINGS AND DISCUSSION

### UNDERSTANDING OF RISK AND BANK'S OPERATING ENVIRONMENT

Employees understanding on bank's missions and general operating environment are the basic principle to create effective risk culture.

**TABLE 1: AWARENESS OF BANK EMPLOYEES REGARDING RISK**

	Strongly disagree	disagree	agree to disagree	agree	Strongly agree	WAS	Ranks
I am aware of mission, vision statements and code of conduct of the bank	5	10	20	53	62	1.9467	2 <sup>nd</sup>
I am well aware of the major risk and scenarios related to the banking business	4	17	22	60	47	1.7200	7 <sup>th</sup>
Managing risk starts by identifying risk	3	9	29	68	41	1.8200	6 <sup>th</sup>
The rules, procedures about risk are well written and documented in the bank	1	13	18	73	45	1.8933	3 <sup>rd</sup>
Upper bank management illustrates positive example for ethical conduct in the bank	3	8	19	60	60	2.0333	1 <sup>st</sup>
My co-workers are performing their job responsibly in aligned manner with rules and regulations	6	8	22	67	47	1.8467	5 <sup>th</sup>
Bank employees understands the core values of the bank and its approach to risk	2	12	20	72	44	1.8667	4 <sup>th</sup>

Source: Field Survey

Note: WAS stands for Weighted Average Score. Weighted average score is calculated using weights as follows: strongly disagree=-2, disagree=-1, agree to disagree=1, agree=2 and strongly agree=3

**Table 1**, Reveals the opinion of 150 respondents towards their understanding on risk and bank's operating environment. Upper bank management illustrates positive example for ethical risk management conduct in the bank occupies first rank with the average mean score of 2.0333; followed by respondent's awareness of mission, vision statements and code of conduct of the bank with the mean of 1.9467. Rules, procedures about risk are well written and documented in the bank. Bank employees understands the core values of the bank and its approach to risk, my co-workers are performing their job responsibly in aligned manner with rules and regulations. Managing risk starts by identifying risk and being aware of risk policy. Respondents are well aware of the major risk and scenarios related to the banking business, weighted average mean score being 1.8933, 1.8667, 1.8467, 1.8200 and 1.7200 respectively

In the view of the above analysis it is inferred that majority of the respondents replied that the upper bank management illustrates positive example for ethical risk management conduct in the bank, and less respondents are aware of the major risk and scenarios related to the banking business.

### THE BANK'S NATURE OF COMMUNICATION

The nature of communication within the bank determines effective risk culture management. It creates the way of information flow and from top down and down top.

**TABLE 2: THE NATURE OF COMMUNICATION IN THE BANK**

	Strongly disagree	disagree	Agree to disagree	agree	Strongly agree	WAS	Ranks
Warning signs about risk are communicated efficiently within the bank departments	11	13	17	66	43	1.6200	4 <sup>th</sup>
Bank reports enhance good risk communication	6	13	32	64	35	1.6000	3 <sup>rd</sup>
Communication between lower and upper management levels of the bank is open and effective	6	14	38	61	31	1.5133	5 <sup>th</sup>
Decision making in the bank are participative	2	15	27	70	36	1.7067	2 <sup>nd</sup>
The bank communicate effectively to customers to ensure account security against risks	4	11	24	61	50	1.8467	1 <sup>st</sup>

Source: Field Survey

Note: WAS stands for Weighted Average Score. Weighted average score is calculated using weights as follows: strongly disagree=-2, disagree=-1, agree to disagree=1, agree=2 and strongly agree=3

**Table 2**, reveals the opinion of 150 respondents towards nature of communication in the banks. The respondents opined in first rank that; The bank communicate effectively to customers to ensure account security against risks with the weighted average score of 1.8467, followed in the second rank by; Decision making in the bank are participative with the weighted average score of 1.7067; Bank reports enhance good risk communication, Warning signs about risk are communicated efficiently within the bank departments, Communication between lower and upper management levels of the bank is open and effective with the mean average score of 1.6200, 1.6000 and 1.5133 respectively.

In view of the above analysis, it is inferred that banks communicate effectively to customers to ensure account security against risks.

### COMPETENCE AND TRAINING OF THE EMPLOYEES

Banks needs employees who are skillful and capable to work. The level of competence depends on the knowledge that employees have. Training helps to build competence of employees.

**TABLE 3: COMPETENCE AND TRAINING OF THE EMPLOYEES**

	Strongly disagree	disagree	Agree to disagree	agree	Strongly agree	WAS	Ranks
The basic knowledge on risk management helps me to perform well bank activities	4	12	16	74	44	1.8400	3 <sup>rd</sup>
The bank risk policy is made known to bank employees	2	11	28	76	33	1.7600	5 <sup>th</sup>
The bank keeps on informing and updating employees on new methods of managing risk	3	4	18	74	51	2.0600	1 <sup>st</sup>
Employees are given tasks to do according to their level of competence	1	8	22	81	38	1.9200	2 <sup>nd</sup>
Risk management training enhance employees performance	1	7	31	74	37	1.8733	4 <sup>th</sup>
Training programs are done for all staff to develop risk management competencies	5	13	29	60	43	1.7000	6 <sup>th</sup>

Source: Field Survey

Note: WAS stands for Weighted Average Score. Weighted average score is calculated using weights as follows: strongly disagree=-2, disagree=-1, agree to disagree=1, agree=2 and strongly agree=3

**Table 3**, reveals the opinion of 150 respondents towards nature of communication in the banks. The respondents opined in the first rank that, the bank keeps on informing and updating employees on new methods of managing risk with the mean average score of 2.0600; followed by Employees are given tasks to do according to their level of competence with the mean average score of 1.9200 in the second rank; The basic knowledge on risk management helps me to perform

well bank activities, Risk management training enhance employees performance, The bank risk policy is made known to bank employees, Training programs are done for all staff to develop risk management competencies, with the mean average score of 1.8733, 1.8400, 1.7600 and 1.7000 respectively.

Based on the above analysis, it is inferred that majority of respondents opined that, the bank keeps on informing and updating employees on new methods of managing risk.

#### BANK'S LEADERSHIP

Bank upper management has the task to lead, guiding and supervising activities and human resource in the bank. The style of leadership determines the risk culture of the bank.

TABLE 4: BANK'S LEADERSHIP STYLE

	Strongly disagree	disagree	Agree to disagree	agree	Strongly agree	WAS	Ranks
I feel comfortable to share possible risk or financial errors with the bank management	3	8	23	63	53	1.9600	5 <sup>th</sup>
Management style of the bank is centralized	2	7	21	80	40	1.9333	6 <sup>th</sup>
management decisions are results of well and clearly communication	5	5	29	69	42	1.8533	7 <sup>th</sup>
Upper bank management have appropriate experience to effectively manage the bank risk profile	0	9	17	67	57	2.0867	4 <sup>th</sup>
The upper bank management act as a good example by following ethics and accountability	0	6	17	64	63	2.1867	2 <sup>nd</sup>
The upper bank management ensures compliance with internal rules and procedures to meet bank business goals	0	5	17	63	65	2.2200	1 <sup>st</sup>
The appropriate tone and standard of behavior 'from the top' is a necessary condition for promoting a sound risk management	0	3	25	68	54	2.1333	3 <sup>rd</sup>

Source: Field Survey

Note: WAS stands for Weighted Average Score. Weighted average score is calculated using weights as follows: strongly disagree=-2, disagree=-1, agree to disagree=1, agree=2 and strongly agree=3

**Table 4**, reveals the opinion of 150 respondents towards the leadership style employed by the banks. The respondents opined in first rank that, the upper bank management ensures compliance with internal rules and procedures to meet bank business goals with the weighted average mean score of 2.2200, followed by, The upper bank management act as a good example by following ethics and doing what they say (accountability) with the mean average score of 2.1867; The appropriate tone and standard of behavior 'from the top' is a necessary condition for promoting a sound risk management, Upper bank management have appropriate experience and skills to effectively manage the bank business and risk profile, I feel comfortable to share possible risk or financial errors with the bank management, Management style of the bank is centralized, management decisions are results of well and clearly communication with the mean average score of 2.1333, 4.1467, 2.0867, 1.9333 and 1.8533 respectively.

In view of the above analysis, it is inferred that, the upper bank management ensures compliance with internal rules and procedures to meet bank business goals.

#### EMPLOYEES PERFORMANCE

Job performance determines motivation, remuneration to the employees. Employee's performance has an impact on risk culture.

TABLE 5: EMPLOYEES PERFORMANCE

	Strongly disagree	disagree	Agree to disagree	agree	Strongly agree	WAS	Ranks
Employees are promoted and rewarded fairly	0	7	22	57	64	2.1400	1 <sup>st</sup>
I always pay attention to the risks that are likely to repeat several time	1	6	21	63	59	2.1067	2 <sup>nd</sup>
Performance is shared periodically in a short time.	4	9	27	65	45	1.8333	5 <sup>th</sup>
Extra pay and benefits are given to employees considering performance in managing risk	2	6	29	74	39	1.8933	3 <sup>rd</sup>
The bank is applying motivation techniques to induce employees to increase work performance	5	6	25	65	49	1.9067	4 <sup>th</sup>

Source: Field Survey

Note: WAS stands for Weighted Average Score. Weighted average score is calculated using weights as follows: strongly disagree=-2, disagree=-1, agree to disagree=1, agree=2 and strongly agree=3

**Table 5**, reveals the opinion of 150 respondents towards performance of employees on risk taking. The respondent opined in the first rank that, Employees are promoted and rewarded fairly with the weighted average mean score of 2.1400; followed in the second rank by I always pay attention to the risks that are likely to repeat several time with the weighted average mean score of 2.1067; Extra pay and benefits are given to employees considering performance in managing risk, The bank is applying motivation techniques to induce employees to increase work performance, performance is shared periodically in a short time, not only at performance evaluation period, with the weighted average mean score of 1.8933, 1.9067 and 1.8333 respectively.

In the above analysis, responses disclose the fact that, bank's employees are promoted and rewarded fairly. This creates good environment for risk management.

#### MANAGEMENT AND GOVERNANCE ACTIVITIES OF BANK'S

Bank's management structure and activities particularly the Board of Directors, determines the risk culture of the bank.

TABLE 6: MANAGEMENT AND GOVERNANCE ACTIVITIES OF BANK'S

	Strongly disagree	disagree	Agree to disagree	agree	Strongly agree	WAS	Ranks
The board regularly review policies to ensure proper controls of risk	2	7	21	63	57	2.0467	2 <sup>nd</sup>
There is risk management committees responsible to measure, control and report to the board	0	6	30	64	50	2.0133	4 <sup>th</sup>
The management structure of the bank support effective risk management	0	3	26	63	58	2.1533	1 <sup>st</sup>
There is structured risk-based reporting system to ensure reports to the board	2	7	23	61	57	2.0333	3 <sup>rd</sup>
The board and senior management demonstrate adherence to sound risk management	7	10	11	75	47	1.8533	5 <sup>th</sup>

Source: Field Survey

Note: WAS stands for Weighted Average Score. Weighted average score is calculated using weights as follows: strongly disagree=-2, disagree=-1, agree to disagree=1, agree=2 and strongly agree=3

**Table 6**, reveals the opinion of 150 respondents towards management and governance activities of the banks. The first rank reveals that, the management structure of the bank support effective risk management with the weighted average score of 2.1533; followed in the second rank by The board regularly review policies to ensure proper controls and risk management process with the weighted average score of 2.0467; There is structured risk-based reporting system to ensure regular

reports to the board with respect to all relevant key risk areas, There is risk management committees responsible to measure, control and report to the board, The board and senior management demonstrate adherence to sound risk management, with the weighted average score of 2.0333, 2.0133 and 1.8533 respectively. In view of the above analysis, it shows that the management structure of the bank support effective risk management.

#### CHALLENGES FACING IMPLEMENTATION OF EFFECTIVE RISK MANAGEMENT

Banks are facing various challenges towards building effective risk management.

**TABLE 7: CHALLENGES FACING IMPLEMENTATION OF EFFECTIVE RISK MANAGEMENT**

	Strongly disagree	disagree	Agree to disagree	agree	Strongly agree	WAS	Ranks
The present general economic environment as well as current legal and regulatory framework	6	13	24	59	58	1.9400	1 <sup>st</sup>
strength of principal competitors in banking business	9	12	11	64	54	1.8067	5 <sup>th</sup>
Exposure to specific risk events including loss of key staff and customers	1	13	17	70	49	1.9267	3 <sup>rd</sup>
Future developments in the general economic environment as well as legal factors	0	5	30	64	51	2.0400	2 <sup>nd</sup>
Poor implementation of risk management guidelines	0	4	31	75	40	1.9800	4 <sup>th</sup>

Source: Field Survey

Note: WAS stands for Weighted Average Score. Weighted average score is calculated using weights as follows: strongly disagree=-2, disagree=-1, agree to disagree=1, agree=2 and strongly agree=3

**Table 7**, reveals the opinion of 150 respondents towards challenges of implementing effective risk management in banks. The first rank challenge is the present general economic environment as well as current legal and regulatory framework with the weighted average score of 1.9400; followed by the Future developments in the general economic environment as well as legal factors with the weighted average score of 4.0733; Exposure to specific risk events including loss of key staff and customers, Poor implementation of risk management guidelines, strength of principal competitors in banking business, with the weighted average score of 4.0200, 4.0067 and 3.9467 respectively.

In view of the above analysis, it shows that, the big challenge facing banks to implement effective risk management is the present general economic environment as well as current legal and regulatory framework.

#### CONCLUSION

Decision-making regarding compensation, recruitment, accountability and risk issues are the core issues of risk culture management. Bank managers and top executives are responsible for the whole review, approval and monitoring of risk culture and acting as an example in abiding with banking roles and ethics in implementing risk culture which often are followed by the lower level employees. The ordering flow of information from the managers keeps lower level employees well informed of the risks that face the bank hence healthy risk management in banking sector. Risk culture is the epicenter of bank's business operations. It includes effective risk awareness of bank employees, the nature of risk communication, risk training, leadership style, and performance of employees, management and governance of the bank. The paper also looked at the bank challenges in implementing risk culture.

#### LIMITATION OF THE STUDY

The study was limited to data collected from bank's officers in Karnataka state in India. There is therefore the need to conduct a comprehensive nationwide survey in order to have a broader, more reliable and robust data base for further analysis and confirmation of the current study outcome.

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