



Risk management in banking sector

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Abstract

As banking sector play an important role in the overall growth of Indian economy. Therefore, management of risk is very crucial task to be performed by all the banks. Although each and every bank has unique risk management mechanism. In the present paper which is completely conceptual in nature, we have tried to study various types of risk faced by banks. Some of them are credit risk, liquidity risk, market risk etc. There after study focuses on the steps to be followed for managing risk.

Keywords: liquidity risk, credit risk, risk management, reputational risk, bank run

Introduction

In the recent years, the banks had faced many challenges many of those can be due to bad lending, poor risk management or lack of adaptability according to changing economic situations. Banking sector play a vital role in Indian economy. Banking sector have to face numbers of risk due to which banking activities are considered to be risky activities. In bank risk can be define as probability of happening of some event because of which earnings or profits of banks could reduce. Therefore, it is essential for the banks to have an effective and efficient risk management system.

Risk management can be defined as the logical development of plans and their execution to deal or manage the potential losses. The main focus of any risk management techniques is to manage the exposure of losses or risk and to maintain or protect the value of its assets. According to Ozturk (2007) risk management is the process with the help of which managers satisfy their risk-taking needs by identifying or defining main risk, planning understandable, consistent and feasible or operational measures, selecting which risk should be increased and which is to decrease and how and thereby establishing system or processes to monitor the risk position. The risk management in banking became mandatory from the year 1997 when the Basel Committee published the “core principles” for the effective supervision of banking sector. From then, banks required to adopt risk management and risk measurement procedure to ensure risk-adjusted return. So, the entire focus of risk management procedure is to ensure safety as well as profitability of banks. The Indian banking sectors is primarily regulated by the Reserve Bank of India Act 1934 and the Banking Regulation Act 1949. Since the RBI is the central bank of India therefore, it issues various guidelines, policies and notifications from time to time to regulate the banking industry. In addition to RBI Act 1934 and BR act 1949, FEMA (Foreign Exchange Management Act) 1999 also regulate the international transactions of banks.

Review of literature

According to Anita K Pennathur (2001) ^[1], the banking industry realises that an important segment of their clients demands a

significance online presence which complement the traditional “bricks and mortar” system to “click and bricks” system. Whereby banks have to face various risk like operational, security, Reputational as well as legal risk 24/7. Therefore, there is a need to have an innovative and proactive system to manage risk. Wolfgang Bauer and Marc Ryser (2004) ^[2] stated that deposits of the bank are one of the important determinants which motivate banks to adopt risk management system because in the absence of efficient risk management system banks might have to face bank run situation. A. A. Kanwar (2005) ^[3] further added that it’s the volatility of global market , innovative products, technological advancement and regulatory environment which all have made risk management as a crucial function for banks because all these factors or variables collectively create risk. Wolf Wanger (2010) ^[5], in his study present that diversification reduces the probability of bank failure for each bank separately but it increases the systematic risk. So one of the controversial issue for diversification is that it may not be beneficial for bank because it increase systematic risk. Pedro Cadenas and Henryk Gzyl (2021) ^[4], argue from this controversy and stated that it depends upon the fact that how the risk is being assessed or measured. Omotola Awojobi and Roya Amel (2011) ^[6] pointed out that risk management efficiency of banks is not just affected by bank specific factors but there are numerous macroeconomic variables which effect efficiency of bank. They termed it as pro-cyclicality of bank performance. Konovalova (2016) ^[8] suggested that the factors affecting credit risk, when lending to individuals are average income of the lender, loan term or maturity period and loan amount.

Objective of the study

Study aims to find out role of banking sector in Indian economy. This paper strive to clarify the concept of risk, which further extended to the types of risk which are faced by the banks. The study also tries to emphasis on relationship between the risk other variables some of them are inside the banks known as internal factors and some of them are external factors which are beyond the control of the banks. At the end study emphasised on the risk

management strategies or system that banks should adopt to manage the credit risk because credit risk is one of the major risk faced by the banks.

Types of risk

From the literature review and introduction section, it must be very clear that risk basically is variability of expected return, which can in other words be define as chances or probability of incurring losses. Loss could be due to customer default, bank run, liquidity crisis, fluctuation in market value of bank assets, operating system of the bank etc. so we can say that in banking business number of risks are involved. We can categorise them as follows:

- Credit Risk
- Liquidity Risk
- Market Risk
- Business Risk
- Operational Risk
- Interest rate risk
- Reputational Risk
- Etc.

Credit risk



Fig 1

It is the possibility or probability of incurring loss from a borrower's inability to repay loan principal amount or interest or both either partially or wholly. This is amongst the top most risk face by banking sector. It arises when borrower fails to meet their schedule debt obligations.

For bearing credit risk, the lender get compensation in form of interest rate. Therefore, the interest rate keeps on varying depending upon the level of risk attached to loan. Banks usually charge high interest rate for high-risk loan. It is also known as default risk. Various factors like borrower's financial position, popular loan agreement or policies, trade restriction, govt. policies are some, which affect credit risk. Banks main activities include the lending or granting loan to individual as well as corporate therefore, credit risk is pervasive in all the banking activities of bank. Although the level or degree of credit risk varies from transaction to transaction.

Liquidity risk



Fig 2

It refers to situation where bank is not in a position to meet its cash obligations on time. Maintaining adequate liquidity in bank all the time is one of their crucial tasks because in the absence of adequate liquidity Bank run situation may arise.

Bank run is the situation where bank show its inability to provide cash in timely manner to few customers because of which other customer also demand cash from their deposits which further reduce the bank's ability to provide fund to customers. There exist many regulations to lessen or reduce the liquidity risk like SLR, CRR. All these regulations ensures that banks maintain adequate liquidity so that whenever customers or clients demand their deposits bank should have that.

Market risk or Systematic risk



Fig 3

Market risk arise due to unpredictability of capital market. Market risk size depends upon the bank's involvement in capital market. Although market risk can be reduced by diversification but cannot be eliminated completely. Other way to reduce the market risk is hedging investment with other inversely related investments. Portfolio investment or diversification is also an important tool for risk reduction related to investment activities.

Business risk



Fig 4

It is the risk arising from long term business plans and strategy of bank. It refers to a situation where bank is not able to keep up with changing dynamics because of competition, losing or reducing market share over a period of time and being closed or take over by competitors.

It may arise because of bank not able to maintain adequate working condition or policies for employee as well as clients. So, it might arise because of choosing wrong strategy which might result into bank failure and closure.

Operational risk



Fig 5

It refers to the risk of loss due to inadequate or failed internal procedure, people and system. Operational risk can also be defined as risk of loss due to fault/error or damages due to processes, people or system. High operational risk may lead to fraud because it allows hackers to steal information about customer. Operational risk has got three component people risk, information technology risk and process related risk. So, there should be strict cyber security mechanism. People risk refers to the loss that banks might have to faced because of inefficient people who are either not capable of doing their task effectively or may be not willing to do so. Information technology risk can be defined as loss which banks faced due to hardware and software failure, viruses human error etc. Process risk can be defined as lack in business activities which may leads to financial, reputational or customer loss.

Interest rate risk

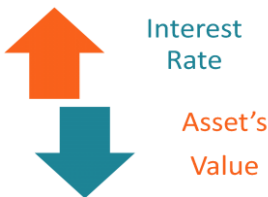


Fig 6

Interest rate risk refers to the potential losses in investment that may arise due to fluctuations in market interest rate. For example, as interest rate increase the value of fixed income investment like bonds, debentures and fixed deposits is reduced. The interest rate risk varies depending upon the timing or term to maturity of bank assets and liabilities.

Reputational risk



Fig 7

Reputational risk refers to danger or threat the standing/ reputation or good name of bank. It occurs due to number of reasons like action of the company, actions of its employee. Therefore, besides having good governance practices and transparency, banks should also be socially responsible and environment aware to avoid or reduce reputational risk. This risk can wipe out market capitalization of bank greatly. Banks can adopt number of policies to manage reputational risk like keeping your employee happy, protect yourself against data breach, be ethical in operations etc.

Managing credit risk

Various risk present in banking industry have been discussed in the above section. Out the various risk discussed above, the credit risk is one of the important risks presents in almost all the business activities of bank. Therefore, the banks need to pay proper attention in managing the credit risk. There should an effective and efficient credit management system in all the banks. Credit risk management process should involve the following:

1. In each and every loan policy of the banks, risk management process should be involved.
2. The banks should take the help for credit scoring or rating of potential customers from the various credit rating agencies.
3. The bank should quantify expected loss and risk through various scientific models.
4. There should be a credit policy committee in each bank which should look after the credit policies and procedure so that, credit risk can be managed.
5. There should be an ideal credit risk environment whereby the board of directors should review risk policies as well as decide the bank's tolerance level for risk.
6. The bank should well defined criteria in term of borrower's credential requirements, sources for repayment.
7. Banks should recruit the intelligent human resources, who should be capable of understanding conditions and factors affecting credit risk.
8. Credit risk management system should be there in each bank consisting of techniques to minimize the adverse effect of credit risk. For example, credit approving authority, portfolio management, prudential limits etc.
9. Banks should conduct credit training program regularly to trained employees with proper knowledge about credit standard.
10. Banks should have effective information system which report highly risky exposure, track status and monitor and control account performance

To sum up the risk management procedure should be good enough to manage and control risk. So that banks should not face risk beyond the limits set by banks as well as banks are able to maintain market share because of which banks could ensure profitability together with security of bank.

Conclusion

Study concluded that banks needed to adopt the efficient and effective policies to manage the risk. The role or importance of risk management is increasing day by day because nowadays banks are operating 24/7 due to the growing role of online transactions, e-banking as well as mobile banking. Banks need to frame its risk management system and need to update or modify

it from time to time to keep a pace with the govt. regulations. In the study we find that various factors like borrower's financial position, loan term and conditions, IT factors, employee, steps taken by bank for the betterment of society, etc. play an important role in the risk framework of bank. Risk management procedure should neither be too strict nor too lenient. The banks have to build its risk management mechanism keeping into the consideration the rules, regulations and guidelines issued by various regulatory bodies.

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