

RISK MANAGEMENT IN BANKING SECTOR: A DESCRIPTIVE ANALYTIC INQUIRY

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Abstract:

As per the Reserve Bank of India (RBI), India's banking sector is sufficiently capitalised and well-regulated. The financial and economic conditions in the country are far superior to any other country in the world. Credit, market and liquidity risk studies suggest that Indian banks are generally resilient and have withstood the global downturn well. The centrality of all banking reformation and banking restricting is all about risk management. All the strategic intent, the tactical maneuvering and operational acumen in banks factor in the concept risk in them. Therefore, owing to the paucity of risk management research in Indian banks, this study was initiated. Attempt here was made to present the risk management practices in banks operated in India using descriptive analytic approach. Results are startling. There are significant variations in the banks approach towards adopting and executing risk management practices.

Introduction

The etymology of the word "Risk" can be traced to the Latin word "Rescum" meaning Risk at Sea or that which cuts. Risk is inherent in every walk of life. Banks are, by definition, in the business of taking and managing risk. With growing competition and fast changes in the operating environment impacting the business potentials, banks are compelled to encounter various kinds of financial and non-financial risks. Risk is associated with uncertainty and reflected by way

of charge on the fundamental/ basic i.e. in the case of business it is the Capital, which is the cushion that protects the liability holders of an institution.

The various risks that a bank is bound to confront is divided into two categories namely business risks and control risks. Business risk involves the risks arising out of the operations of the bank, the business it is into and the way it conducts its operations. It consists of 8 types of risks namely capital, credit, market, earnings, liquidity, business strategy and environmental, operational and group risk. Control risk measures the risk arising out of any lapses in the control mechanism such as the organizational structure and the management and the internal controls that exist in the bank. Controls risk further consists of internal controls, management, organizational and compliance risk. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. Thus, top management of banks should attach considerable importance to improve the ability to identify measure, monitor and control the overall level of risks undertaken.

The three main categories of risks in the capital accord are: Credit Risk, Market Risk and Operational Risk. Credit risk, a major source of loss, is the risk that customers fail to comply with their obligations to service debt. Major credit risk components are exposure, likelihood of default, or of a deterioration of credit standing, and the recoveries under default. Modelling default probability directly with credit risk models remains a major challenge,

not addressed until recent years. Market Risk may be defined as the possibility of loss to bank caused by the changes in the market variables. Market risk management provides a comprehensive and dynamic frame work for measuring, monitoring and managing liquidity, interest rate, foreign exchange and equity as well as commodity price risk of a bank that needs to be closely integrated with the bank's business strategy. Operational risk involves breakdown in internal controls, personnel and corporate governance leading to error, fraud, and performance failure, compromise on the interest of the bank resulting in financial loss. Putting in place proper corporate governance practices by itself would serve as an effective risk management tool. The practical difficulties lie in agreeing on a common classification of events and on the data gathering process.

Risk management in banking designates the entire set of risk management processes and models allowing banks to implement risk-based policies and practices. They cover all techniques and management tools required for measuring, monitoring and controlling risks. The spectrum of models processes extends to all risks: credit risk, market risk, interest rate risk, liquidity risk and operational risk, to mention only major areas.

Regulators make the development of risk-based practices a major priority for the banking industry, because they focus on 'systematic risk', the risk of the entire banking industry made up of financial institutions whose fates are intertwined by the density of relationships within the financial system. Banking failures have been numerous in the past, both in India and internationally. Banking failures make risk material and convey the impression that the industry is never far away from major problems. Regulators have been very active in promoting pre-emptive policies for avoiding individual. Bank failures and for helping the industry absorbs the shock of failures when they happen. To achieve these results, regulators have totally renovated the regulatory framework. They are promoting

and enforcing new guidelines for measuring and controlling the risks of individual players.

From the banks point of view risk based practices are so important, because banks being 'risk machines', they take risks, they transform them, and they embed them in banking products and services. Banks take risk-based decisions under an ex-ante perspective and they do risk monitoring under an ex-post perspective, once the decisions are made. There are powerful; motives to implement risk based practices to provide a balanced view of risk and return from a management point of view; to develop competitive advantages, to comply with increasingly stringent regulations. It is easy to lend and obtain attractive revenues from risky borrower. The price to pay is a risk that is higher than the prudent bank's risk. The prudent bank limits risk and therefore both future losses and expected revenues by restricting business volume and screening out risky borrowers. It might avoid losses but it might suffer from lower market share and lower revenues. However, after a while, the risk-taker might end with an ex-post performance lower than the prudent bank due to higher losses materializing. Risks remain intangible and invisible until they materialize into losses. Simple solutions simply do not really help to capture risks. All these factors led to the commencement of this study.

Indian banking industry has recently witnessed the roll out of innovative banking models like payments and small finance banks. RBI's new measures may go a long way in helping the restructuring of the domestic banking industry.

The digital payments system in India has evolved the most among 25 countries with India's Immediate Payment Service (IMPS) being the only system at level 5 in the Faster Payments Innovation Index (FPII).*

In August 2017, Global rating agency Moody's announced that its outlook for the Indian banking system was stable. In November 2017, Global rating agency Moody's upgraded

four Indian banks from Baa3 to Baa2.

Risk is uncertainty in any business. As such, banks are also not from risky. Banks, especially banks are always prone to risk, as they have maintain liquidity, solvency and also make the profits by lending the loans to the general public. Hence the risk is common in banks. The various types of risks include systematic risk, operational risks, liquidity risks, credit risks, security risks are described. To reduce these risks, there are different plans and decisions should be taken by the banks. Such plans of actions are discussing in the paper. There is need for a systematic plan and strategy to reduce the risk by the banks in India. Even with the help of external financial and legal agencies. Banking is a risky business due to liberalization policies in India. Various steps for efficient management of risks and control of risks are discussed in detail. Separate risk management plan should be forecasted by the banks to control the risks.

Background

The Indian banking system consists of 27 public sector banks, 26 private sector banks, 46 foreign banks, 56 regional rural banks, 1,574 urban cooperative banks and 93,913 rural cooperative banks, in addition to cooperative credit institutions. Public-sector banks control more than 70 per cent of the banking system assets, thereby leaving a comparatively smaller share for its private peers. Banks are also encouraging their customers to manage their finances using mobile phones.

As the Reserve Bank of India (RBI) allows more features such as unlimited fund transfers between wallets and bank accounts, mobile wallets are expected to become strong players in the financial ecosystem.

The unorganized retail sector in India has huge untapped potential for adopting digital mode of payments, as 63 per cent of the retailers are interested in using digital payments like mobile and card payments, as per a report by Centre for Digital Financial Inclusion (CDFI).

Key investments and developments in India's banking industry include:

The bank recapitalisation plan by Government of India is expected to push credit growth in the country to 15 per cent and as a result help the GDP grow by 7 per cent in FY19. ^

Public sector banks are lining up to raise funds via qualified institutional placements (QIP), backed by better investor sentiment after the Government of India's bank recapitalisation plan and an upgrade in India's sovereign rating by Moody's Investor Service.

Literature Review

Kaminsky and 71 balance of payments crises in the period 1970-1995. Regarding the influence of Reinhart (1996) in their well-known paper on twin-crises study about 25 episodes of banking crises business cycle on the episode of financial instability and the possibility to identify macro-variables that act as early warning, they find that recessionary conditions such as economic activity decline, weakening of the export sector, high real interest rates, falling stock market, usually precede banking as well as currency crises. They also find that Credit expansions, an abnormally high money growth and the decline in the terms-of-trade anticipate many of the banking crises.

Berger and Deyoung (1997) address a little examined intersection between the problem loan literature and the bank efficiency literature. They employ Granger-casualty techniques to test four hypotheses regarding the relationship among loan quality, cost efficiency, and bank capital. The data suggest that the intertemporal relationships between problem loans and cost efficiency ran in both directions for U.S. commercial banks between 1985 and 1994. The data suggest that high levels of nonperforming loans Granger-cause reductions in measured cost efficiency, consistent with the hypothesis

that the extra costs of administering these loans reduces measured cost efficiency ('bad luck'). The data also suggest that low levels of cost efficiency Granger-cause increases in nonperforming loans, consistent with the hypothesis that cost-inefficient managers are also poor loan portfolio managers ('bad management').

In the paper by Mario Quayliariello (1997), the relationship between bank loan quality and business cycle indicators is studied for Italy. A distributed lag model (which is estimated using ordinary least squares) and bivariate Granger-causality tests are used in order to evaluate the importance of macroeconomic factors in predicting the quality of bank loans measured by the ratio of non-performing loans to total loans. The main target of the research is to understand the contribution that macro-data can offer in capturing the evolution of credit quality and to select a reasonably manageable set of indicators which can act as early warning signals of the banking system fragility.

Demirguc-Kunt and Detragiache (1998) estimate a logit model of banking crises over the period 1980-1994 in order to understand the features of the economic environment in the periods preceding a banking crisis and, therefore, to identify the leading indicators of financial distress.

The 1998 study by Demirguc-Kunt and Huizinga (DKH) is a cross-country study of variations in bank performance, using two performance indicators separately regressed on a set of explanatory factors; the interest spread (used as an efficiency indicator) and bank profitability. The data set is at bank level for 80 countries over the period 1988-95. The most important finding pertains to the differences in the impact of foreign ownership between developed and developing countries. In developing countries foreign banks have greater interest margins and profits than domestic banks. In industrial countries, the opposite is true. The first finding bears out

the better NPA performance by foreign banks in India by country of origin. Among the macro variables reported by DKH that affect bank profitability positively although not net interest margins (the efficiency indicator), is per capita GDP. These results suggest that per capita GDP may be less a correlate of banking efficiency or superior banking technology, and more a correlate of banking opportunities and the operating environment generally.

The Sarkar, Sarkar and Bhaumik (1998) cross-bank study for India regresses two profitability and four efficiency measures (one of which is the net interest margin) on pooled data for two years, 1993-94 and 1994-95, for a total of 73 banks, using single-equation OLS estimation for each. The study focuses exclusively on an examination of the prediction from the property rights literature about the superiority of private ownership in terms of performance. Private banks are divided into traded and non-traded categories; the control variables include the (log of) total bank assets, the proportion of investment in government securities, the proportion of loans made to the priority sector, the proportion of semi-urban and rural branches and the proportion of non-interest income to total income.

Ajit and Bangar (1998) present a tabulation of the performance of private sector banks vis-à-vis public sector banks over the period 1991-1997, using a number of indicators: profitability ratio, interest spread, capital adequacy ratio, and the net NPA ratio. The conclusion is that Indian private banks outperform public sector banks. What is of interest, however, is that they find Indian private banks have higher returns to assets in spite of lower spreads.

Survey on the "Implementation of the Capital Adequacy Directive" by the Banking Federation of the European Union, April 1998 (covering 17 countries) revealed that very few banks are using sophisticated models for managing their risks. Most banks which use it at first place use it for internal risk management

purposes only.

Shaffer (1998) shows that adverse selection has a persistent effect on the banks which are new entrants in a market. Salas and Saurina (1999b) have modelled the problem loans ratio of Spanish banks in order to gauge the impact of loan growth policy on bad loans. According to their empirical estimation results (which were achieved using a panel data of commercial and savings banks from (1985-1997), the cycle (measured through the current and lagged-one-year GDP growth rates) has a negative and significant impact on problem loans. The current impact is much more important. It is also shown that problem loans ratio differs by type of loan. Households and firms have different levels of bad loans. On an average, the former is lower than the latter. Among households, mortgages have very low delinquency levels compared to consumer loans, credit loans or overdrafts.

Gambera (2000), using bivariate VAR systems, tries to understand how economic development affects bank loan quality. He points out that, since systemic financial conditions help predict the soundness of the single intermediaries; it may be interesting to predict the systemic financial conditions themselves. In particular, he uses the ratio of delinquencies to total loans and the ratio of non-performing loans to total loans as alternative dependent variables and he estimates a bivariate system for each series of macro-economic variables.

Eichengreen and Arteta (2000) carefully analyse the robustness of the empirical results on banking crises using a sample of 75 emerging markets in the period 1975-1997 and considering a huge range of explanatory variables mentioned in previous works. Their findings confirm that unsustainable boom in domestic credit is a robust cause of financial distress; macro-economic policies leading to rapid lending growth and financial overheating generally set the stage for future problems. Domestic interest-rate liberalization

often accompanies these excessive lending activities. On the other hand, they point out that there is little evidence of any particular relationship between exchange-rate regimes and banking crises; the role of the legal and regulatory framework is also uncertain.

Meyer and Yeager (2001) employ a set of county macro-economic variables to test if rural bank performance is affected by the local economic framework. They fit an OLS model when the return on assets and the net loan losses are the dependent variables and a tobit specification for the nonperforming loans. They find that none of the county-level coefficients is significant, suggesting that county economic activity does not have a relevant effect on bank performance; in contrast, state –level data are significant.

Arpa et al., (2001) study the effects of the business cycle on risk provisions and earnings of Austrian banks in the 1990s. They conclude that risk provisions increase in period of falling real GDP growth, confirming the pro-cyclical tendencies in bank behaviour. Moreover, rising real estate prices lead to higher provisions, whereas falling inflation depresses them. They also find that some macro-economic variables such as interest rates, real estate and consumer prices are useful in explaining the profitability of Austrian banks.

In 2001 Boston Consulting Group study confirmed the general impression that North American banks have a clear lead on most of their European and Asian competitors. Institutions in the U.S. and in Australia too for that matter were pursuing risk management not to comply with regulatory requirements but to enhance their own competitive positions.

Conclusion

Risk management is of cardinal concern for banks offering financial services in conditions of uncertainty. The turmoil of the banks emphasizes the need and importance of effective risk management procedures. Encouraged by such concern, this thesis will

address “Enterprise risk management practices and effectiveness of such practices in banks” while, collecting data with the help of a self-completion questionnaire from banks in India. The bank management which is directly responsible for risk management will respond to the structured questionnaire. This research addresses a set of ERM practices namely, because risk management is an important part of the financial industry. Besides, ERM effectiveness is vital to increased project success

Secondly, ERM practices in select banks have been analysed in relation to various factors like, like of banks, ownership, Specialisation,

services offered and the volume of operations, etc. this way, inter-bank variations in ERM practices and ERM effectiveness will be understood.

Thirdly, the model of ERM effectiveness will be tested. In this model, the relationships between ERM practices namely, and ERM effectiveness will be tested. This way, new patterns of ERM practices can be evolved for future practice and also for future research directions.

Thus, the research idea includes assessment of relationship between ERM practices and ERM effectiveness in select banks.