Risk management in banking industry

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Abstract

Risk is very important element in financial sector. Without risk management no any bank can be survives in banking sector. Risk is define as the fluctuations or anticipation changes in return. There are many types of risk are presented in banking sector like credit risk, liquidity risk or operational risk etc. in this paper researcher want to study the identification of risk faced by the banking sector and what technique are adopted by the bank to manage their risk.

***Keywords**:*

Risk management, banking sector, credit risk and liquidity risk

Introduction

Risk can be define as the any difficulty occurs in the way to achieve a particular objective. This difficulty can be occur due to internal or external factor. For avoiding any negative result due to risk it is necessary to take proactive step to identify and analyze the particular risk and take steps to minimize the risk. Risk management is a planned method of dealing with the anticipated loss.

In banking sector, banks faces many types of risk like credit risk, liquidity risk and operational risk. Due to these risk the return and profit of the banking sector are effected. Risk are exist in both type of sector; public sector bank and private sector bank.

Need of the study

Due to liberalization many reform are made in banking sector. But some difficulties are faced by banking sector due to liberalization. At present, banking sector faces many challenges. These challenges are exist in the form of risk. Like public sector bank have competition from private sector. Sometimes non-performing assets are presented in the banks. So it is necessary for the banks to identify risk that are occur. And take necessary measure to minimize this. Regards the RBI guidelines and Basel committee rule, the investigation of risk analysis is more important.

Objective of the study

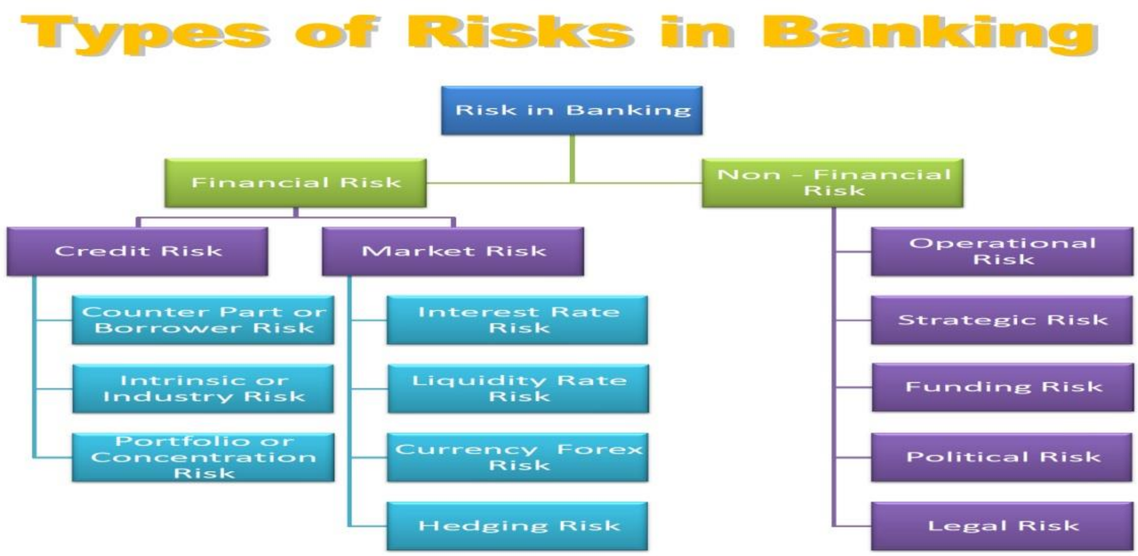
1) study about risk faced by the banking industry
2) To examine the technique adopted by bank for management of risk.
3) To study the role of RBI in risk management in banks.

Research methodology

This paper is theoretical modal based on the extensive research for which secondary data are used which is collected from various online websites, books and journal.

Types of risk in banking sector

Like another industry, banks also exist in dynamic environment. There are many factor present in the environment in the form of risk that effect the profitability of banks. For surviving it's necessary for banks to make adjustment with these factor. The types of risk based on the situation or related factor. There are following types of risk:-



Financial risk

This risk arise due to business transaction done by bank. This risk have two types:-

1) **Credit risk**

Credit risk is defined as the potential of a bank borrower or counterparty is failed to meet its obligation according to the term and condition. In another words, when interest or principal or both will not be paid according to promise then this risk occur. when the NPA level of the banks is high then more chances of this risk. Credit risk can be manage through following way:-

a) **Exposure ceiling**

Bank can decide the limit for distribution its capital fund like 20% for individual borrower entity, 40% for a group and 40% for infrastructure project.

b) **Review/renewal:**

Credit approving authority can be review the client's asset time to time.

c) **Risk rating model**

Customer should be rated according to some scale and these rating should be reviewing periodically.

d) **Risk based scientific pricing**
High risk category borrower are to be priced high.

e) **Portfolio management**
According to this bank should be provide to loan to various group, industry. Banks can be diversified their fund.

Component of credit risk

i. **Transaction risk**
This risk focus on inconsistency in credit quality and earning resulting from how the bank underwrites individual loan transaction. This risk has three dimension: selection, underwriting and operation.

ii. **Intrinsic risk**
It focuses on the risk built in certain line of business and loan to certain industry. Loan that are gives for commercial real estate is more risky than consumer loan. This risk include three factor:-

- **Historical element** : direct prior performance and stability of the industry or line of business.
- **Predictive element**: this include changes that effect industry positively or negatively.
- **Lending element**: focus on how the collateral or term offered in industry.

iii. **Concentration risk**
The risk related with any single exposure or group of exposure which produce losses and negatively influence the core operation of banking.

iv. **Country risk**
This risk arise when borrower and lender belong to different countries. And due to changes in foreign exchange rate and political factor this risk are occur.

2) Market risk
This risk arise due to changes in market variable like change in interest rate, foreign exchange, equity and commodity price. The following are types of market risk:-

i. **Liquidity risk:**
This risk arise when funding of long term asset by short term liabilities. It can be define as when any institution does not pay their maturing commitment. And when they acquiring their fund at high cost and dispose their asset at low cost. This risk have following types:-

- **Funding risk**
  It is define as the inability to obtain fund to meet cash flow obligation.
- **Time risk**
  This risk arise when performing asset convert into nonperforming asset. expected flow of fund have not chance of receipt.
- **Call risk**
  This risk associate with contigent liabilities. And bank have not position in to make profit from business opportunities.

ii. **Interest rate risk**

This risk arise due to movement in interest rate and negatively effect the net interest income. Changes in interest rate influence the value of asset, earning and cash flow. The following are the types of interest rate risk:-

- **Gap or mismatch risk**

  This risk arise when any bank holding assets and liabilities and off balance sheet item with different principal amount and maturity date. It mean any liability fund by asset which have different maturity period.

- **Yield curve risk**

  This risk occur when unexpected change in the shape and slope of yield curve and effect the economic value of the financial asset. If the same type of instrument generate unequal yield then it lead to yield curve risk.

- **Basis risk**

  Sometime, reference rate are used to price asset and liability. If there are different change in reference rate then it adversely affect the earning. For example, if the interest rate on the loan was fixed according to LIBOR (London interbank offered rate) and interest on investment to fund the loan was fixed according to Treasury bill of the government with same maturity. But at the time of repricing both rate are changed.

- **Embedded option risk**

  This risk arise due to option exercised by customer, fund supplier or option holder swap. For example, if the issuer of bond held by bank may exercise an option to buy back of coupon rate decline in the financial market. If counterparty exercise this option then bank may face loss.

- **Reinvested risk**

  It take place from uncertainty about the interest rate at which future cash flow could be reinvested. Net interest income may be vary because of any mismatch between cash inflow cash outflow. This is due to fact that interest received on loan and to pay for deposit moving in different direction.

- **Net interest position risk**

  This risk appear because of market interest rate is lowered and bank have more earning asset than paying liabilities. If the market interest rate decrease then net interest income also decrease and vice versa. This influence the earning of bank and economic value of assets and liabilities.

iii. **Foreign exchange risk**

This risk caused by fluctuations in exchange rate during the period. There is also the risk of payment due to the partner’s refusal, payment of one case in one center and payment of another currency at another time.

Non-financial risk

Non-financial risk present in banks because of failure of strategies, management and non-availability of product/services. This risk affect the bank’s business growth and marketability of its product and services. Types of non-financial risk are as follows:-

1) **Operational risk**
This risk happen because of inadequate or failed internal processes, people and system or from external event. The main reason of this risk when staff does not have knowledge of technical skill to handle transaction and lack of honesty and integrity in their work.
2) **Strategic risk**
Strategic risk is the risk of adverse business decision, wrong decision or lack of response to change in the industry. This risk depend on the organization's strategic objective, the business strategy developed to obtain these objective.
3) **Legal risk**
Legal risk arise from the uncertainty of consequence of legal suits filed by the bank in account of law or from legal action taken against it by third parties. It also arise when obligation are not perform according to law.

Technique of risk management

1) **Gap analysis**
This is interest rate risk management tool based on balance sheet that focuses on the prospective volatility of net interest income over a specific period of time. in this method, asset, Liabilities and off balance sheet item distribute in time band according to their maturity period if interest is fixed. After re pricing, asset are called rate sensitive asset (RSA) and liabilities are called rate sensitive liabilities (RSL).
GAP= RSAs _ RSLS

2) **Value at risk**
This is one of the new risk management tool. This indicate how much a firm can lose or make with a profitability over a specific period of time. It provide summary of financial risk involve in portfolio. VAR is used to measure overall market risk factor such as foreign exchange, commodities and capital.

3) **Risk adjusted rate of return or capital(RAROC**)
it provide an economic basis for continuously assessing all relevant risk and provide manager with a tool for making effective decision about the balance of risk and return between asset. Since economic capital protect financial institution from unforeseen losses. It is important to allocate capital to various risk faced by these institution. RAROC (return on equity) show what economic capital is needed for various product and companies and find out the total return on the company's capital.

4) **Securitization**
This is the proposed process in structured finance or credit. Securitization is a technique for raising new fund and reduce the risk of a bank. It is the process of transferred the illiquid asset into tradeable asset which are backed by securities. Return from these securities depend on the cash flow of the underlying asset.

5) **Sensitivity analysis**
In this technique analyst determine the effect of one variable in relation to other. One variable is preassumed and changes in expected variable how are effect the target variable.

6) **Internal rating system**
This tool is used to manage the credit risk. In this technique credit worthiness of the borrower and quality of credit transaction are managed in such a way that reduce the credit risk faced by the lender.

Role of RBI in risk management in bank

The RBI has been using CAMELS rating to evaluate the financial soundness of the bank. This model include of six component; capital adequacy, asset quality, management, earning quality, liquidity and sensitivity to the market risk.

CAMEL is recommended by Basel committee in 1988. Then it does not include sensitivity but in 1997, this component added in CAMEL called CAMELS.

Before the revolution of the BIS prudential reform banking regulation mainly focus on licensing, administration of minimum capital requirement, pricing of services like interest rate on deposit as well as credit.

But after the BIS reform in 1988 the RBI took a service measure to improve its regulatory standard make compatible with international best practices after considering the socio economic condition of the country and payment system.

Finally in 1999, RBI reorganized the need of appropriate risk management and issue guideline related to asset liability management, management of credit, market and operation risk. In 1994, BFS demand the need of strong and stable financial system. And in 1999, the rating of Indian banks are on the basis CAMELS and for foreign bank on the basis of CACS (capital, asset quality, compliance and system and control) recently BFS also provide basis for onsite and offsite supervision of banks.

Conclusion

Risk is very important of banking sector. Main purpose of this paper, to provide information about various risk present in the banks and various technique to manage the risk. RBI also take measure to control the risk by setting up risk management cells and also through internal assessment of their risk exposure. Apart from this, RBI has opted for on-site and off-site surveillance methods for effective risk management in the Indian Banking sector.

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