Research Guru
Online Journal of Multidisciplinary Subjects (ISSN : 2349-266X)
UGC Approved Journal No. 63726
Impact Factor:3.021 website: www.researchguru.net
Volume-11,Issue-3,December-2017

RISK MANAGEMENT IN INDIAN BANKS: SOME ISSUES AND CHALLENGES

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Abstract
The fast changing financial environment exposes the banks to various types of risk. The concept of risk and management are core of financial enterprise. The financial sector especially the banking industry in most emerging economies including India is passing through a process of change. Rising global competition, increasing deregulation, introduction of innovative products and delivery channels have pushed risk management to the forefront of today's financial landscape. Ability to gauge the risks and take appropriate position will be the key to success. This paper attempts to discuss in depth, the importance of risk management process and throws light on challenges and opportunities regarding implementation of Basel-II in Indian Banking Industry.

Keywords: Risk Management, Banking Sector, Credit risk, Market risk, Operating Risk, Forex, Risk management

1. INTRODUCTION

Risk is defined as anything that can create hindrances in the way of achievement of certain objectives. It can be because of either internal factors or external factors, depending upon the type of risk that exists within a particular situation. Exposure to that risk can make a situation more critical. A better way to deal with such a situation; is to take certain proactive measures to identify any kind of risk that can result in undesirable outcomes. In simple terms, it can be said that managing a risk in advance is far better than waiting for its occurrence. Risk Management is a measure that is used for identifying, analyzing and then responding to a particular risk. It is a process that is continuous in nature and a helpful tool in decision making process. According to the Higher Education Funding Council for England (HEFCE), Risk Management is not just used for ensuring the reduction of the probability of bad happenings but it also covers the increase in likeliness of occurring good things. A model called “Prospect Theory” states that a person is more likely to take on the risk than to suffer a sure los.

2. Definition of Risk

Definition of Risk A risk can be defined as an unplanned event with financial consequences resulting in loss or reduced earnings (Vasavada, Kumar, Rao & Pai, 2005). An activity which may give profits or result in loss may be called a risky proposition due to uncertainty or unpredictability of the activity of trade in future. In other words, it can be defined as the uncertainty of the outcome.

Risk refers to ‘a condition where there is a possibility of undesirable occurrence of a particular result which is known or best quantifiable and therefore insurable’ (Periasamy, 2008). Risk may mean that there is a possibility of loss or damage which, may or may not happen.

Current Definition of 'Risk Management:

Definition: In the world of finance, risk management refers to the practice of identifying potential risks in advance, analyzing them and taking precautionary steps to reduce/curb the risk.[1]

Description: When an entity makes an investment decision, it exposes itself to a number of financial risks. The quantum of such risks depends on the type of financial instrument. These financial risks might be in the form of high inflation, volatility in capital markets, recession, bankruptcy, etc.[2]

So, in order to minimize and control the exposure of investment to such risks, fund managers and investors practice risk management. Not giving due importance to risk management while making investment decisions might wreak havoc on investment in times of financial turmoil in an economy. Different levels of risk come attached with different categories of asset classes.[3]

For example, a fixed deposit is considered a less risky investment. On the other hand, investment in equity is considered a risky venture. While practicing risk management, equity investors and fund managers tend to diversify their portfolio so as to minimize the exposure to risk.[4]

3. OBJECTIVES THE STUDY

1. To understand the concept, meaning and definition of risk management.

2. To study the various type of Risk in banking.

3. To study the process and system of risk management.

4. RESEARCH METHODOLOGY

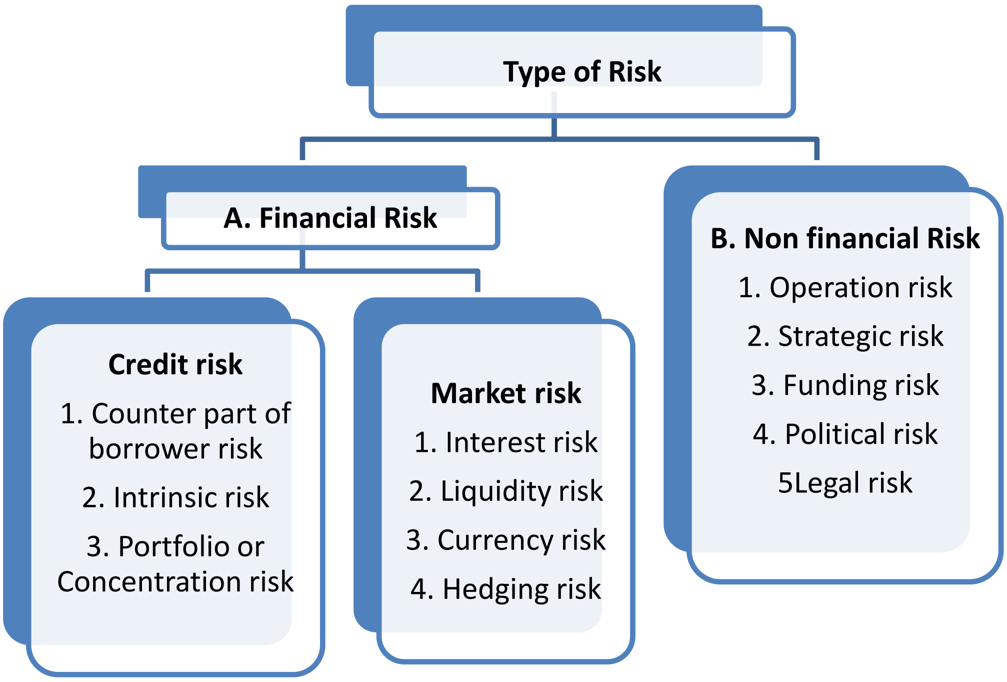
[1] www. economictimes.com
[2] www. economictimes.com
[3] www. economictimes.com
[4] www. economictimes.com

This paper is theoretical modal based on the extensive research for which the secondary source of information has gathered. The sources include online publications, Books and journals.

5. Various Type of Risk in banking sector.

In view of growing complexity of banks,, business and the dynamic operating environment, risk management has become very significant, especially in the financial sector. Risk at the apex level may be visualized as the probability of a banks,, financial health being impaired due to one or more contingent factors. While the parameters indicating the banks,, health may vary from net interest margin to market value of equity, the factor which can cause the important are also numerous. For instance, these could be default in repayment of loans by borrowers, change in value of assets or disruption of operation due to reason like technological failure. While the first two factors may be classified as credit risk and market risk, generally banks have all risks excluding the credit risk and market risk as operational risk.[5]

Type of Risk



A. FINANCIAL RISK Financial risk arises from any business transaction undertaken by a bank, which is exposed to potential loss. This risk can be further classified into Credit risk and Market risk.

Credit Risk: Credit risk is defined as the possibility of losses associated with decrease in the credit quality of the borrower or the counter parties. In the bank's portfolio, losses stem from outside default due to inability or unwillingness of the customer or the counter party to meet

[5]Thirupathi kanchu and Manoj kumar (2013) www.indianresearchjournals.com

the commitments, losses may also result from reduction in the portfolio value arising from actual or perceived deterioration in credit quality.[6]

Market Risk: Market risk is the risk of incurring losses on account of movements in market prices on all positions held by the banks. Liquidity risk of banks arises from funding of long term assets (advances) by short term sources (deposits) changes in interest rate can significantly affect the Net Interest Income (NII). The risk of an adverse impact on NII due to variations of interest rate may be called interest rate risk. Forex risk is the risk of loss that bank may suffer on account of adverse exchange rate movements against uncovered position in foreign currency.[7]

Non-Financial Risk: Non-financial risk refers to those risks that may affect a bank's business growth, marketability of its product and services, likely failure of its strategies aimed at business growth etc. These risks may arise on account of management failures, competition, non-availability of suitable products/services, external factors etc. In these risk operational and strategic risk have a great need of consideration. [8]

Operational Risk: It may be defined as the risk of loss resulting from inadequate or failed internal process people and systems or because of external events. [9]

Strategic Risk: Strategic risk is the risk that arises from the inability to implement appropriate business plans and strategies, decisions with regard to allocation of resources or adaptability to dynamic changes in the business/operating environment. These are a number of other risk factor through which operations risk, credit risk and market risk may manifest. It should be recognized that many of these risk factors are interrelated, one results to other. [10]

6. Process of Risk Management: To overcome the risk and to make banking function well, there is a need to manage all kinds of risks associated with the banking. Risk management becomes one of the main functions of any banking services risk management consists of identifying the risk and controlling them, means keeping the risk at acceptable level. These levels differ from institution to institution and country to country. The basic objective of risk management is to stakeholders; value by maximizing the profit and optimizing the capital funds for ensuring long term solvency of the banking organization. In the process of risk management following functions comprises: [11]

- Risk identification
- Risk measurement or quantification
- Risk control
- Monitoring and reviewing

[6] Dr. Krishna A Goyl and Sunita Agrawal (2010) IJER | DEC 2010. pp- 103
[7] Dr. Krishna A Goyl and Sunita Agrawal (2010), ibid pp- 103
[8] Dr. Krishna A Goyl and Sunita Agrawal (2010), ibid pp-104
[9] Dr. Krishna A Goyl and Sunita Agrawal (2010), ibid –pp- 104
[10] Dr. Krishna A Goyl and Sunita Agrawal (2010), ibid pp-105
[11] Dr. Krishna A Goyl and Sunita Agrawal (2010), ibid pp-106

Risk Identification: The risk identification involves 1. the understanding the nature of various kinds of risks. 2. the circumstances which lead a situation to become a risk situation and 3. causes due to which the risk can arise. [12]

Risk Quantification: Risk quantification is an assessment of the degree of the risk which a particular transaction or an activity is exposed to. Though the exact measurement of risk is not possible but the level of risk can be determined with the help of risk rating models.

Risk Control: Risk control is the stage where the bank or institutions take steps to control the risk with the help of various tools.

Tools for Risk Control

- Diversification of the business
- Insurance and hedging
- Fixation of exposure ceiling
- Transfer the risk to another party at right time
- Securitization and reconstruction

Risk Monitoring: In risk monitoring the bankers have to fix up the parameters on which the transaction is to be tested to be sure that there is no risk to viable existence of the financial unit or investment of the bank.

7. **Challenges in the Indian context:**

Basel II is intended to improve safety and soundness of the financial system by placing increased emphasis on bank's own internal control and risk management processes and models, the supervisory review process and market discipline. Indeed, to enable the calculation of capital requirements under the new accord requires a bank to implement a comprehensive risk management framework. However, these changes will also have wide ranging effects on bank's information technology systems, processes, people and business, beyond the regulatory compliance, risk management and finance functions. Though every bank has to invest lot of time, manpower and energy in the implementations of Basel II, yet it helps the banks to assess the risks associated with the business effectively. More so, it facilitates the banks to produce quantified and more realistic measure of the risk. Basel II enables the banks to handle business with more confidence and make better business decisions. But the techniques and the methods suggested in the new accord would pose considerable implementation challenges for the banks especially in a developing country like India; some of them are described as under:[13]

1. Implementation of the new framework will require substantial resources and commitment on the part of both banks and supervisors. Banks are required to make enormous improvements in the areas of policies, organizational structure, MIS, tools for analysis, process, specified training of staff etc. It will involve huge cost both for the banks as well as for supervisors.

[12] Dr. Krishna A Goyl and Sunita Agrawal (2010), ibid pp-106

[13] Dr. Krishna A Goyl and Sunita Agrawal (2010), ibid pp-107

2. To provide the basis for forecasting and building of models in respect of various activities, such as loaning, security and foreign exchange transactions, a lot of historical data is required. In the Indian context major handicap is the absence of data series, particularly, related to the transactions in individual loan accounts.
3. The new capital accord assigns risk-weight of sovereign at 0-50%. These 13 also a higher risk weight to the small and medium enterprises. In India, the PSBs have more than 40 percent of their lending to priority sector. The implementation of Basel II can adversely affect the priority sector lending.
4. Even the G-10 countries are finding it difficult to implement the Basel II accord in all the banks. Therefore, longer time may be required for its implementation in some or all the banks in India.
5. In India, credit rating is restricted to issues and not to the issuers. While Basel II gives some scope to extend the rating of issues to issuers. This would be an approximation and it would be necessary for the system to move to the rating of issuers. Encouraging rating of issuers would be a challenge.

9. Conclusion

Risk is an opportunity as well as a threat and has different meanings for different users. The banking industry is exposed to different risks such as Forex volatility, risk, variable interest rate risk, market play risk, operational risks, credit risk etc. which can adversely affect its profitability and financial health. Risk management has thus emerged as a new and challenging area in banking. Basel II intended to improve safety and soundness of the financial system by placing increased emphasis on bank's own internal control and risk management process and models. The supervisory review and market discipline. Indeed, to enable the calculation of capital requirements under the new accord requires a bank to implement a comprehensive risk management framework. Over a period of time, the risk management improvements that are the intended result may be rewarded by lower capital requirements. However, these changes will also have wide-ranging effects on a bank's information technology systems, process, people and business, beyond and regulatory compliance, risk management and finance function. The task of integrating Basel II is challenging. Indian banks have come a long way since independence and more so after LPG era, however, still they have to cover some distance so as to be bench marked with the best banks globally. But one thing is for sure that the reform process is on and the Indian banks are in the right direction. They have adopted best structures, processes and technologies available worldwide and have moved from strength to strength. Still the future poses various challenges for the banking industry.

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