RISK MANAGEMENT STRATEGIES IN BANKING INDUSTRY

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Abstract

In this paper it tried to discuss the various risk associated to a bank and the strategies to be adopted to minimize the risks of the banks. It is also tried to explain the prescribe procedures for risk identification, measurement and assessment, as well as procedures for risk management.

Keywords: Market exposure, Credit Risk, Systemic risk, Operational risk and Moral hazard

INTRODUCTION

In the course of their operations, banks are invariably faced with different types of risks that may have a potentially negative effect on their business. Risk management in bank operations includes risk identification, measurement and assessment, and its objective is to minimize negative effects risks can have on the financial result and capital of a bank. Banks are therefore required to form a special organizational unit in charge of risk management. Also, they are required to prescribe procedures for risk identification, measurement and assessment, as well as procedures for risk management. The risks to which a bank is particularly exposed in its operations are: liquidity risk, credit risk, market risks (interest rate risk, foreign exchange risk and risk from change in market price of securities, financial derivatives and commodities), exposure risks, investment risks, risks relating to the country of origin of the entity to which a bank is exposed, operational risk, legal risk, reputational risk and strategic risk.

OBJECTIVE OF THE STUDY

To study the risks associated to a bank particularly exposed in its operations with reference to liquidity, credit, market exposure, investment and other related activities.The financial industry in the US is the most liquid and the largest market in the world. In 2014, finance and insurance represented 7.2 percent of U.S. GDP. The banking industry in the US supports the world's largest economy with the greatest diversity in banking institutions and concentration of private credit. The banking industry has awakened to risk management, especially since the global crisis during 2007-08. But what are the day to day risks and the long term risks faced by banks? Why do dedicated risk management practices at companies like FIS Global even exist? Which risks are their risk management products and services meant for? Here's the list of 8 risks faced by banks:

CREDIT RISK

According to the Bank for International Settlements (BIS), credit risk is defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Credit risk is most likely caused by loans, acceptances, interbank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions. In simple words, if person A borrows loan from a bank and is not able to repay the loan because of inadequate income, loss in business, death, unwillingness or any other reasons, the bank faces credit risk. Similarly, if you do not pay your credit card bill, the bank faces a credit risk.

Hence, to minimize the credit risk on the bank's end, the rate of interest will be higher for borrowers if they are associated with high credit risk. Factors like unsteady income, low credit score, employment type, collateral assets and others determine the credit risk associated with a borrower. As stated earlier, credit risk can be associated with interbank transactions, foreign transactions and other types of transactions happening outside the bank. If the transaction at one end is successful but unsuccessful at the other end, loss occurs. If the transaction at one end is settled but there are delays in settlement at the other end, there might be lost investment opportunities. Look at it like person A sending US dollars to his family in India at the rate of 60 INR (Indian Rupee) per dollar. The person B, who is the recipient however receives the payment late and doesn't get the exchange rate of 60 INR. Instead he receives the money at the exchange rate of 58 INR. This means they incurred a loss in the transaction. Similar situations occur during big transactions in banks. If the bank is not able to settle a transaction at an expected time or during an expected time duration, they may incur a credit risk. However, this kind of risk is called "Settlement Risk" and it is closely associated with credit risk. It depends on the timing of the exchange of value, payment/settlement finality and the role of intermediaries and clearing houses.

While some credit risk is a result of macro forces affecting the economy or specific markets or even specific individuals, there is another important risk that can be classified under credit risk: this is the risk of deliberate fraud that is usually borne by the banks who issue credit products such as credit cards.

MARKET RISK

McKinsey defines market risk as the risk of losses in the bank's trading book due to changes in equity prices, interest rates, credit spreads, foreign-exchange rates, commodity prices, and other indicators whose values are set in a public market. Bank for International Settlements (BIS) defines market risk as the risk of losses in on- or off-balance sheet positions that arise from movement in market prices. Market risk is prevalent mostly amongst banks who are into investment banking since they are active in capital markets. Investment banks include Goldman Sachs, Bank of America, JPMorgan, Morgan Stanley and many others.

Market risk can be better understood by dividing it into 4 types depending on the potential cause of the risk:

1. Interest rate risk: Potential losses due to fluctuations in interest rate

2. Equity risk: Potential losses due to fluctuations in stock price

3. Currency risk: Potential losses due to international currency exchange rates (closely associated with settlement risk)

4. Commodity risk: Potential losses due to fluctuations in prices of agricultural, industrial and energy commodities like wheat, copper and natural gas respectively

OPERATIONAL RISK

According to the Bank for International Settlements (BIS), operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputation risk. Operational risk can widely occur in banks due to human errors or mistakes. Examples of operational risk may be incorrect information filled in during clearing a check or confidential information leaked due to system failure.

Operational risk can be categorized in the following way for a better understanding:

1. Human risk: Potential losses due to a human error, done willingly or unconsciously

2. IT/System risk: Potential losses due to system failures and programming errors

3. Processes risk: Potential losses due to improper information processing, leaking or hacking of information and inaccuracy of data processing

Operational risk may not sound as bad but it is. Operational risk caused the decline of Britain's oldest banks, Barings in 1995. Since banks are becoming more and more digital and shifting towards information technology to automate their processes, operational risk is an important risk to be taken into consideration by the banks.

Security breaches in which data is compromised could be classified as an operational risk, and recent instances in this area have underlined the need for constant technology investments to mitigate the exposure to such attacks.

LIQUIDITY RISK

Investopedia defines liquidity risk as the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. However if you find this definition complex, the term 'liquidity risk' speaks for itself. It is the risk that may disable a bank from carrying out day-to-day cash transactions.

Look at this risk like person going to a bank to withdraw money. Imagine the bank saying that it doesn't have cash temporarily! That is the liquidity risk a bank has to save itself from. And this is not just a theoretical example. A small bank in Northern England and Ireland was taken over by the government because of its inability to repay the investors during the 2007-08 global crisis.

REPUTATIONAL RISK

The Financial Times Lexicon defines reputation risk as the possible loss of the organisation's reputational capital. The Federal Reserve Board in the US defines reputational risk as the potential loss in reputational capital based on either real or perceived losses in reputational capital.

Just like any other institution or brand, a bank faces reputational risk which may be triggered by bank's activities, rumors about the bank, willing or unconscious non-compliance with regulations, data manipulation, bad customer service, bad customer experience inside bank branches and decisions taken by banks during critical situations. Every step taken by a bank is judged by its customers, investors, opinion leaders and other stakeholders who mould a bank's brand image.

BUSINESS RISK

In general, Investopedia defines business risk as the possibility that a company will have lower than anticipated profits, or that it will experience a loss rather than a profit. In the context of a bank, business risk is the risk associated with the failure of a bank's long term strategy, estimated forecasts of revenue and number of other things related to profitability. To be avoided, business risk demands flexibility and adaptability to market conditions. Long term strategies are good for banks but they should be subject to change. The entire banking industry is unpredictable. Long term strategies must have backup plans to avoid business risks. During the 2007-08 global crisis, many banks collapsed while many made way out it. The ones that collapsed didn't have a business risk management strategy.

Systemic risk and moral hazard are two types of risks faced by banks that do not causes losses quite often. But if they cause losses, they can cause the downfall of the entire financial system in a country or globally.

SYSTEMIC RISK

The global crisis of 2008 is the best example of a loss to all the financial institutions that occurred due to systemic risk. Systemic risk is the risk that doesn't affect a single bank or financial institution but it affects the whole industry. Systemic risks are associated with cascading failures where the failure of a big entity can cause the failure of all the others in the industry.

MORAL HAZARD

Moral hazard is a risk that occurs when a big bank or large financial institution takes risks, knowing that someone else will have to face the burden of those risks. Economist Paul Krugman described moral hazard as "any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly. Economist Mark Zandi of Moody's Analytics described moral hazard as a root cause of the subprime mortgage crisis of 2008-09

The Risk Management in Banking programme draws on more than 25 years of research organised by the Centre of International Financial Services, a partnership launched in 1987 between selected financial institutions and INSEAD. The programme uses lectures, discussion and work group to develop participants' risk management skills in the following areas:

1. Risk governance
2. Credit and market risks
3. Liquidity risk and fund transfer pricing
4. Operational risk

THE ALCO CHALLENGE

The ALCO Challenge is a computer simulation designed at INSEAD. It recreates an international banking environment, allowing participants to perfect their skills in long-term value creation and risk control. Participants perform the simulation in teams, each team forming an Asset-Liability Committee. The ALCO Challenge incorporates the latest financial techniques in profitability and risk management. It is entirely accurate, taking into account the effects of taxation and Basel 3 capital and liquidity regulations.

The educational objectives of the ALCO Challenge are fivefold:

1. Value creation
2. Value-based pricing
3. Risk management
4. Negotiation
5. Teamwork

Since this programme is aimed at giving a holistic view of risk control in financial services firms, the target audience is senior bank executives or board members concerned with risk governance and their overall management, and senior bankers in various functional areas who need to inform themselves about the process of risk control.

CONCLUSIONS

It can be concluded that to minimize the credit risk on the bank's end, the rate of interest will be higher for borrowers if they are associated with high credit risk. Factors like unsteady income, low credit score, employment type, collateral assets and others determine the credit risk associated with a borrower. Market risk is prevalent mostly amongst banks who are into investment banking since they are active in capital markets.. Systemic risk is the risk that doesn't affect a single bank or financial institution but it affects the whole industry. Moral hazard is a risk that occurs when a big bank or large financial institution takes risks, knowing that someone else will have to face the burden of those risks.

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