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# Sustainable risk management in banking sector

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**Abstract**
Risk Management is the application of proactive strategy to plan, lead, organize, and control the wide variety of risks that are rushed into the fabric of an organization's daily and long-term functioning. Like it or not, risk has a say in the achievement of our goals and in the overall success of an organization. Present paper is to attempt to identify the risks faced by the banking industry and the process of risk management. To achieve the objectives of the study data has been collected from secondary sources. Finally, it can be concluded that the banks should take risk more consciously, anticipates adverse changes and hedges accordingly; it becomes a source of competitive advantage, and efficient management of the banking industry. As depicted from the risks, the banks have to manage more types of risks in order to maximize the shareholders' wealth. The most important categories of risks include credit risk, interest rate risk, liquidity risk and operational risk. Credit risk arises when a bank cannot get back the money from loans or investments. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise. The solvency of the bank would be threatened when the bank cannot fulfill its promise to pay a fixed amount to depositors because of the decline in the value of the assets caused by increase in interest rate. Liquidity risk arises when the bank is unable to meet the demands of depositors and needs of borrowers by turning assets into cash or borrow funds when needed with minimal loss. Finally yet importantly, operational risk arises out of inability to control operating expenses, especially noninterest expenses such as salaries and wages. In a competitive environment, high operational expenses would jeopardize the bank's prospects to survive.

**Keywords:** risk management, credit risk, commercial bank, financial risk, interest rate risk, liquidity risk, sustainable growth, basel

## Introduction
Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks viz., credit, interest rate, foreign exchange rate, liquidity, equity price, commodity price, legal, regulatory, reputational, operational, etc. These risks are 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. Until recently, all the activities of banks were regulated and hence operational environment was not conducive to risk taking. Better insight, sharp intuition and longer experience were adequate to manage the limited risks. Of late, banks have grown from being a financial intermediary into a risk intermediary at present. In the process of financial intermediation, the gap of which becomes thinner and thinner, banks are exposed to severe competition and hence are compelled to encounter various types of financial and non-financial risks. Risks and uncertainties form an integral part of banking which by nature entails taking risks. Rekha Arunkumar and Koteshwar (2006) feel that the is the oldest and biggest risk that Banks, the pro cyclicality effects of the new capital requirements proposed by the Basel Committee, and then conclude with some remarks on the general relevance of our results.. This is part of the initial study on management and its effect in financial performance of universal banks. Basel II requires addressing and managing the market risk and operational risk in addition to the existing (as per Basel I). Basel II capital standard is acting as a major catalyst for enrichment of risk management practices within the bank embedding the risk culture in the banks operation. In response to the new The quality of management, good or bad, matters a lot to banks which absorb the financial risks in exchange of benefits as their essence of business.

## Objectives of the study
- To identify the credit risks faced by the banking industry.
- To trace out the process and system of risk management.
- To study the effectiveness of Credit Risk Mgt. methods.

## Review of literature
Risk Management and Risk based Supervision in Banks has been the subject of study of many Agencies and Researchers and Academicians. There is a treasure of literature available on the subject. Some of these are:
Rekha Arun Kumar and Koteshwar (2006) feel that the Credit Risk is the oldest and biggest risk that Banks, by virtue of their very nature of business inherit. The pre-dominance of credit risk is the main component in the capital allocation. As per their estimate, credit risk takes the major part of the Risk Management apparatus accounting for over 70 percent of all Risks. As per them the Market Risk and Operational Risk are important, but more attention needs to be paid to the Credit Risk Management in Banks.
S.K. Bagchi (2005) feels that so much of concern on

Operational Risk is misplaced. As per him, it may be just one to two percent of Bank's Risk. For this small fraction, instituting an elaborate mechanism may be unwarranted. A well laid out Risk Management System should give its best attention to Credit Risk and Market Risk.

Mrudul Gokhale (2009) elaborately dealt with the subject of Capital Adequacy in Banks. As per her, Banks mostly give adequate focus for Credit Risk aspect. There is a shift from the qualitative risk assessment to the quantitative management of risk. In tune with the regulatory insistence on capturing risks for the purpose of capital charge, sophisticated risk models are being developed. These models help Banks to near accurately quantify the potential losses arising from different risks viz., credit risk, market risk and operations risk.

**Types of risks**

Credit Risk, Interest Rate Risk, Liquidity Risk, Operational Risk, Other Risks

**Credit Risk**

Credit Risk is the potential that a bank borrower/counter party fails to meet the obligations on agreed terms. There is always scope for the borrower to default from his commitments for one or the other reason resulting in crystallization of credit risk to the bank. These losses could take the form outright default or alternatively, losses from changes in portfolio value arising from actual or perceived deterioration in credit quality that is short of default.

**Management of credit risk**

The management of credit risk includes:

- Measurement of risk through credit rating/scoring;
- Quantifying the risk through estimating expected loan losses;
- Risk pricing on a scientific basis; and
- Controlling the risk through effective Loan Review Mechanism and portfolio management.

**Tools of Credit Risk Management**

The instruments and tools, through which credit risk management is carried out, are detailed below:

- **Credit Approving Authority:** Each bank should have a carefully formulated scheme of delegation of powers. The banks should also evolve multi-tier credit approving system where the loan proposals are approved by an 'Approval Grid' or a 'Committee'. The spirit of the credit approving system may be that no credit proposals should be approved or recommended to higher authorities, if majority members of the 'Approval Grid' or 'Committee' do not agree on the creditworthiness of the borrower. In case of disagreement, the specific views of the dissenting member/s should be recorded.
- **Risk Rating:** As observed by RBI, Credit Risk is the major component of risk management system and this should receive special attention of the Top Management of the bank. The process of credit risk management needs analysis of uncertainty and analysis of the risks inherent in a credit proposal. The predictable risk should be contained through proper strategy and the unpredictable ones have to be faced and overcome. Therefore, any lending decision should always be preceded by detailed analysis of risks and the outcome of analysis should be taken as a guide for the credit decision.
- **Risk Pricing:** Risk-return pricing is a fundamental tenant of risk management. In a risk-return setting, borrowers with weak financial position and hence placed in high credit risk category should be priced high. Thus, banks should evolve scientific systems to price the credit risk, which should have a bearing on the expected probability of default. The pricing of loans normally should be linked to risk rating or credit quality.
- **Portfolio Management:** The existing framework of tracking the Non Performing Loans around the balance sheet date does not signal the quality of the entire Loan Book. Most of international banks have adopted various portfolio management techniques for gauging asset quality. The portfolio quality could be evaluated by tracking the migration (upward or downward) of borrowers from one rating scale to another.
- **Loan Review Mechanism (LRM):** LRM is an effective tool for constantly evaluating the quality of loan book and to bring about qualitative improvements in credit administration. Banks should, therefore, put in place proper Loan Review Mechanism for large value accounts with responsibilities assigned in various areas such as, evaluating the effectiveness of loan administration, maintaining the integrity of credit grading process, assessing the loan loss provision, portfolio quality, etc.

**Interest risk management tools**

- **Maturity Gap Analysis:** The Maturity GAP analysis is probably the most widely used technique for assessing interest rate risk. It compares the value of assets that either mature or are repriced within a given time interval to the value of liabilities that either mature or are repriced during the same time. In a typical GAP management process, bank management divides all assets and liabilities on the balance sheet according to their interest rate sensitivity. An asset or a liability with an interest rate subject to change within a year is considered rate sensitive. One whose interest rate cannot change for more than a year is considered fixed. The GAP can be expressed either as dollars or as a percentage of total earning assets. If RSA is greater than RSL, the GAP is positive; if RSA is less than RSL, the GAP is negative; and if RSA is equal to RSL, the GAP is zero. The GAP between rate- sensitive assets (RSA) and rate-sensitive liabilities (RSL) is defined as

  GAP = RSA- RSL

- **Value-at-Risk (VaR):** Value-at-Risk (VaR) is a statistic that measures and quantifies the level of financial risk within a firm, portfolio or position over a specific period. It is a statistical technique used to measure and quantify the level of financial risk within a firm or investment portfolio over a specific period. This metric is most commonly used by investment and commercial bank to determine the extent and occurrence ratio of potential losses in their institutional portfolios. Risk managers in order to measure and control the level of risk exposure use

Value at risk. Value at risk calculations can be applied to specific positions or portfolios as a whole or to measure firm-wide risk exposure.

- **Gap analysis:** Simple maturity/pricing schedules can be used to generate simple indicators of the interest rate risk sensitivity of both earnings and economic value to changing interest rates. When this approach is used to access the interest rate risk of current earnings, it is typically referred to gap analysis. Gap analysis was one of the first methods developed to measure a bank interest rate risk exposure and continues to widely use by banks. To evaluate earning exposure, interest rate sensitive assets to produce a reprcing "gap" for that time band. This gap can be multiplied by an assumed change in interest rates to yield an approximation of the change in net interest income that would result from such an interest rate movement.

**Conclusion**

Based on the above, we can conclude that there are no banking transactions without risk, so it is necessary to ensure adequate risk management process in a bank in order to avoid any negative consequences for a bank and its assets and liabilities. The risk should be first identified and then effectively measured, regulated and managed. All this should be done under the supervision of the competent authority. Banks cannot eliminate risks, but the mission and the main task of each bank should be to minimize them to the extent possible. Risk management underscores the fact that the survival of an organization depends heavily on its capabilities to anticipate and prepare for the change rather than just waiting for the change and react to it. The objective of risk management is not to prohibit or prevent risk taking activity, but to ensure that the risks are consciously taken with full knowledge, clear purpose and understanding so that it can be measured and mitigated. Risk Management Committee, Credit Policy Committee, Asset Liability Committee, etc are such committees that handle the risk management aspects. Regarding use of risk management techniques, it is found that internal rating system and risk-adjusted rate of return on capital are important. The effectiveness of risk measurement in banks depends on efficient Management Information System, computerization and net working of the branch activities.

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