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RESEARCH ARTICLE

TYPES OF RISKS AND RISK MANAGEMENT IN THE CONTEMPORARY BANKING OPERATIONS

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Abstract

Risk Management is a discipline at the core of every financial institution and encompasses all the activities that affect its risk profile. Commercial banks cope with many risks, the most important of which are credit, market, operational and liquidity risks. As modern banking technologies develop, new risks occur. Statistical risk management methods, that combined with other management methods give good results, are becoming more popular and widely used. In order to adapt risk management systems most commercial banks will have to make changes in their risk management odels. The present study showed how various methods could be adapted to improve and adapt risk management model. Calculation of risk would be an essential requirement in the banks as they would be in the process of calculating not only the Credit Risk but also the Market The present paper highlights the various risks faced by banks. The paper presents various methods and models for managing various risks seeing the present scenario and suggests suggestions to manage risk. The paper highlights the various challenges and strategies for managing risk in banks.

INTRODUCTION

Risk taking is an inherent element of banking and, indeed, profits are in part the reward for successful risk taking in business. On the other hand, excessive and poorly managed risk can lead to losses and thus endanger the safety of a bank's depositors. The article sets out minimum standards that shall be expected of a risk management framework at any banking institution. For the purpose of these guidelines, risk in a banking organization refers to the possibility that the outcome of an action or event could bring adverse impacts on the institution’s capital, earnings or its viability. Such outcomes could either result in direct loss of earnings and erosion of capital or may result in imposition of constraints on a bank’s ability to meet its business objectives. These constraints could hinder a bank’s capability to conduct its business or to take advantage of opportunities that would enhance its business. As such, managers of banking institutions are expected to ensure that the risks an institution is taking are warranted.

Risks are considered warranted when they are understandable, measurable, controllable and within a banking institution’s capacity to readily withstand adverse results. Risk management systems enable managers of banking institutions to take risks knowingly, reduce risks where appropriate and strive to prepare for a future, which by its nature cannot be predicted with absolute certainty. Risk Management is a discipline at the core of every banking institution and encompasses all activities that affect its risk profile. Managers of banking institutions should attach considerable importance to improve the ability to identify, measure, monitor and control the overall risks assumed.

Risk management

The financial market is extremely volatile due to the influence of various factors,objective or subjective; the credit institutions being aware of the fact that maximisingprofit implies a permanent incur of risk.Most definitions of the risk and risk management are focused on the classical functionof money, that of intermediary in the field of financial risks through their division. Fromthis point of view it is usually regarded the problem of unexpected losses in bank assets,losses caused by market, credit or liquidity risks.The risk may have a considerable impact over the bank or financial institution, both animpact consisting in the incurred direct losses, and an impact consisting in the effectsover the customers, personnel, business partners and even over the bank authority.In general, the risk represents the probability of occurrence of an event that willproduce serious consequences for the subject. In the same context, it should bementioned that for the risk exposure to be actual value of all losses or supplementaryexpenses the financial institution would or could cover. According to this definition, therisk exposure may be real or potential.It is important to know that the risk is generated by a large number of operations andprocedures. Therefore, in the financial field at least, the risk must be considered as amistune or a complex of risks, usually independent through common targets or the factthat the occurrence of one risk may cause a chain occurrence of other risks. As aconsequence, these operations and procedures permanently generate a risk exposure.[1]

Banking risks are those risks the banks are confronted with in their current operations, and not only the risks specific to the classic banking activity. It is obviously that a notable banking strategy must include both programs and procedures of managing banking risks; regarding the minimisation of the probability the risks would occur the potential exposure of the bank. The three objectives of the bank management are maximising profitability, minimising the risk exposure and observing the banking regulations. None of them has a major influence, as a task of the bank management consists of in establishing the central objective for each period. Banks are also subject to all the risks that their customers face, risks as diverse as crop failure, environmental damage claims or the failure of a new product developed at a high cost. The most significant and persistent risk faced by banks is credit risk – the risk that counterparts will be unable to meet their obligations. Credit risk arises from lending to individuals, companies, banks and governments, from entering into market transactions which give rise to a receipt on maturity, from stock lending and from transactions with supplies. [2]

In the modern banking business one of the most important functions of management is risk management. Risk management, according to the knowledge theorists, is actually a combination of management of uncertainty, risk, equivocality and error . Uncertainty, where outcome cannot be estimated even randomly, arises due to lack of information and this uncertainty gets transformed into risk where estimation of outcome is possible as information gathering progresses. As information about markets and knowledge about possible outcomes increases, risk management provides solution for controlling risk. Equivocality arises due to conflicting interpretations and the resultant lack of judgment. This happens despite adequate knowledge of the situation. That is why, banking as well as other institutions develop control systems to reduce errors, information systems to reduce uncertainty, incentive system to manage agency problems in risk-reward framework and cultural systems to deal with equivocality.[3]

Risk management is often performed by an organizational unit, ideally an independent staff function reporting directly to the board of directors, making risk management a board responsibility and task. The board has to set strategic targets and ensure, via strict controls, that the delegated goals are actually achieved within the centrally mandated guidelines. Running a risk management function in a centralized manner is advantageous because it allows for an independent, integrated view of all types of risk, so that only the net positions need to be managed and specialized staff can achieve better pricing in the capital markets. Management has to develop strategic goals for the various risk areas that are proportionate with the ultimate objective to maximize company value. The goal of risk management should be to identify any uneconomic risk taking, in other words, to ensure that any risk management activity is consistent with value maximization. The ultimate objective should not be to minimize, or worse, to avoid all risks, but it should be to find the optimal balance between risks taken and expected returns, concentrating on the competitive advantage of the company.

Types of risks in banking

Banks like any other commercial organisation also intend to take risk, which is inherent in any business. Higher the risk taken, higher the gain would be. But higher risks may also result into higher losses. However, banks are prudent enough to identify, measure and price risk, and maintain appropriate capital to take care of any eventuality.

The major risks in banking business are listed below: liquidity risk, interest rate risk, market risk, credit risk and operational risk.

1. Liquidity Risk - The liquidity risk of banks arises from funding of long-term assets by short-term liabilities, thereby making the liabilities subject to rollover or refinancing risk. It can be also defined as the

possibility that an institution may be unable to meet its maturing commitments or may do so only by borrowing funds at prohibitive costs or by disposing assets at rock bottom prices. The liquidity risk in banks manifest in different dimensions as: funding risk, time risk and call risk.

Funding Liquidity Risk is defined as the inability to obtain funds to meet cash flow obligations. For banks, funding liquidity risk is crucial. This arises from the need to replace net outflows due to unanticipated withdrawal or non-renewal of deposits.

Time risk arises from the need to compensate for non-receipt of expected inflows of funds i.e., performing assets turning into non-performing assets.

Call risk arises due to crystallisation of contingent liabilities. It may also arise when a bank may not be able to undertake profitable business opportunities when it arises.

2. Interest rate risk - Interest Rate Risk arises when the net interest margin or the market value of Equity of an institution is affected due to changes in the interest rates. Interest rate risk arises when there is a mismatch between positions, which are subject to interest rate adjustment within a specified period. The bank's lending, funding and investment activities give rise to interest rate risk. The immediate impact of variation in interest rate is on bank's net interest income, while a long term impact is on bank's net worth since the economic value of bank's assets, liabilities and off-balance sheet exposures are affected. Consequently there are two common perspectives for the assessment of interest rate risk. Interest rate risk, sometimes called funding risk, involves the effect in the bank profitability of changes on the market interest rates. Interest rate risk refers to the financial risks caused by the interest rate fluctuations that affect both the profit obtained by the client and the indebtedness degree to the bank. A major increase of the interest rate may determine a financial pressure for the client's activity, which will not be able to repay the amounts due. The main factors that increase the interest rate risk are: volatility of interest rates and mismatches between the interests reset dates on assets and liabilities. The main factors that mitigate interest rate risk are: established limits on mismatch position; hedging with financial futures or other instruments; management monitoring exposure.

3. Market risk - The risk of adverse deviations of the mark-to-market value of the trading portfolio, due to market movements, during the period required to liquidate the transactions is termed as Market Risk. This risk results from adverse movements in the level or volatility of the market prices of interest rate instruments, equities, commodities, and currencies. It is also referred to as Price Risk.Price risk occurs when assets are sold before their stated maturities. In the financial market, bond prices and yields are inversely related. The price risk is closely associated with the trading book, which is created for making profit out of short-term movements in interest rates.

The market risk refers to the unfavourable variations of the market value of the positions during the minimum period of time needed to the settlement of the positions. This risk appears due to the fact that the prices of these financial values are determined on the market, and they are modified.

4. Credit risk - Credit risk may be defined as the risk that a counterparty of a financial transaction will fail to perform according to the term and conditions of the contract, thus causing the asset holder to suffer loss. This failure may be the result of bankruptcy, a temporary change in market conditions, or other factors adversely affecting the borrower's ability to pay. The most obvious example of a credit risk is the risk that a customer will fail to repay a loan. However, it is important to appreciate that credit exposure extends to a large variety of bank's activities including the extensions of commitments and guarantees, acceptances, trade finance transactions, placements and the range of capital markets instruments activity such as foreign exchange, futures, swaps, bonds, options, equities and bullion. Credit risk may also arise from off balance sheet transactions. A bank may guarantee a client's performance under a contract in return for a fee giving rise to the risk that the bank may be called upon to fulfil its guarantee at some later date because its client has failed to meet its contractual obligations. This gives rise to a counterclaim against the guaranteed party for the money paid out under the guarantee. Credit risk may take the form of delivery or settlement risk. Where a bank buys securities from a third party or transfers securities under a repurchase agreement, it faces a risk that the counterpart will be unable to deliver the securities on the due date leaving the bank exposed to the possibility that it will not be able to replace the securities at the same price.

5. Operational risk - Basel Committee for Banking Supervision has defined operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Thus, operational loss has mainly three exposure classes namely people, processes and systems. Managing operational risk has become important for banks because a higher level of automation in rendering banking and financial services and increase in global financial inter-linkages. Scope of operational risk is very wide because of the above mentioned reasons. Two of the most common operational risks are transaction risk and compliance risk. [4]

Transaction risk is the risk arising from fraud, both internal and external, failed business processes and the inability to maintain business continuity and manage information.

Compliance risk is the risk of legal or regulatory sanction, financial loss or reputation loss that a bank may suffer as a result of its failure to comply with any or all of the applicable laws, regulations, codes of conduct and standards of good practice. It is also called integrity risk since a bank's reputation is closely linked to its adherence to principles of integrity and fair dealing.

Conclusion

Risks are unavoidable in banking business, proper assessment of risk is an integral part of a bank's risk management system. Banks are focusing on the magnitude of their risk exposure and formulating strategies to tackle those effectively.The essence of risk management is not avoiding or eliminating risk but deciding which risks to exploit, which ones to let pass through to investors and which ones to avoid.

Risk management prevents an organization from suffering unacceptable loss that can cause failure or can materially damage its competitive position. Risk management should be a continuous and developing process which runs throughout the organization's strategy and the implementation of that strategy. It should address as many of the risks surrounding the organization's activities past, present and in particular, future, as possible. In the case of a bank, functions of risk management should actually be bank specific dictated by the size and quality of balance sheet, complexity of functions, professional manpower and the status of management information system in place in that bank. Balancing risk and return is not an easy task as risk is subjective and not quantifiable, whereas return is objective and measurable. The extent, to which a bank can take risk more consciously, can anticipate the adverse changes and reacts accordingly, is a determinant of its competitive advantage, as it can as it can offer its products at a better price than its competitors.

Risk management must be integrated into the culture of the organization with an effective policy and a program led by the senior management. It must translate the strategy into tactical and operational objectives, assigning responsibility throughout the organization with each manager and employee responsible for the management of risk as part of their job description.

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