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Risk management and Indian Banking: Opportunities and Challenges

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Abstract:

This paper aims to address the growing need for new standards in the management of two major risks financial entities face - credit risk and liquidity risk, in the context of this phenomenon extremely large and complex, by identifying risks, analyzing them and presenting their management techniques.

Taking into account the fact that the banking system plays a crucial role in any national economy as a central pillar in its functions: lending the real economy and acting as a payment system-base regulation and prudential supervision of the banking system is the main component and also a prerequisite for ensuring and maintaining the financial and economic health of a country. Regardless of the approach, credit risk is the main cause of bank failures and from here the need for the imposition of minimum requirements in managing credit risk and also liquidity risk is seen as the risk of disruptions in providing liquid funds of the bank.

The ultimate goal of this paper is to minimize the consequences arising from the banks activity or at least allow it to absorb only the optimal amount of this type of risk.

Keywords:

Risk, liquidity risk, management techniques, risk exposure, capital markets, Risk Management, Global Banking, Employee and Customer Retention.

Introduction:

In recent time, we has witnessed that the World Economy is passing through some intricate circumstances as bankruptcy of banking & financial institutions, debt crisis in major economies of the world and euro zone crisis. The scenario has become very uncertain causing recession in major economies like US and Europe. This poses some serious questions about the survival, growth and maintaining the sustainable development.

However, amidst all this turmoil India's Banking Industry has been amongst the few to maintain resilience. The tempo of development for the Indian banking industry has been remarkable over the past decade. It is evident from the higher pace of credit expansion; expanding profitability and productivity similar to banks in developed markets, lower incidence of non- performing assets and focus on financial inclusion have contributed to making Indian banking vibrant and strong. Indian banks have begun to revise their growth approach and re-evaluate the prospects on hand to keep the economy rolling.
In this paper an attempt has been made to review various challenges which are likely to be faced by Indian banking industry.

Structure of Indian banking industry:

Banking Industry in India functions under the sunshade of Reserve Bank of India - the regulatory, central bank. Banking Industry mainly consists of:

- ✓ Commercial Banks
- ✓ Co-operative Banks

The commercial banking structure in India consists of: Scheduled Commercial Banks Unscheduled Bank. Scheduled commercial Banks constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934.

RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42 (60) of the Act. Some co-operative banks are scheduled commercial banks although not all co-operative banks are. Being a part of the second schedule confers some benefits to the bank in terms of access to accommodation by RBI during the times of liquidity constraints. At the same time, however, this status also subjects the bank certain conditions and obligation towards the reserve regulations of RBI.

Various Types of Risks:

- ❖ **Financial Risks**
- ✓ **Credit Risk**
- ▪ Counter Part or Borrower Risk
- ▪ Intrinsic or Industry Risk
- ▪ Portfolio or Concentration Risk

- ✓ **Market Risk**
- ▪ Interest Rate Risk
- ▪ Liquidity Risk
- ▪ Currency Forex Risk
- ▪ Hedging Risk

- ❖ **Non-Financial Risk**
- ▪ Operational Risk
- ▪ Strategic Risk
- ▪ Funding Risk
- ▪ Political Risk
- ▪ Legal Risk

The connection between credit and liquidity risk:

While I have emphasized so far credit risk management, I would also like to touch upon the more elusive concept of liquidity risk. The current financial crisis has been triggered by the inability of some financial institutions to fund some complex assets. It has been traditionally thought that while such a situation may put the institution at strain, it should be clearly distinguished from that of insolvency. However, the experience of the last three years has showed that the distinction is far from simple. A prolonged period of liquidity difficulties may easily leave no other choice to the institution than an emergency sale of assets at significant losses and a subsequent depletion of its capital position. Therefore a liquidity problem, if it cannot be properly addressed – possibly by the intervention of the central bank- can easily lead to insolvency.

Still the calibration of the proposed liquidity standards needs to be revisited to take into account the comments received during the public consultation and their impact on the banking sector, financial markets and the overall economy. Finally, the establishment of an appropriate phase-in period that will allow banks to adjust their balance sheets without an undue impact on their operations or an increase

in their reliance on central bank funding is warranted.

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.

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.

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.

Risk Management in Bank:

- **Minimum Capital Requirement (Pillar I)**

The Minimum Capital Requirement (MCR) is set by the capital ratio which is defined as (Total Capital - Tier I + Tier II + Tier III) / credit risk + market risk + operational risk). Basel I provided for only a credit risk charge. A market risk was implemented in 1996 amendments. In the initial stage, all banks are required to follow standardized approach in credit risk, basic indicator approach in operational risk and standardized duration approach in market risk. Migration to higher approaches will require RBI permission. Higher approaches are more risk sensitive and may reduce capital requirement for banks following sound risk management.

- **Supervisory Review Process (Pillar II)**

The supervisory review process is required to ensure adequacy as well as to ensure integrity by the risk management processes. The Basel Committee has started four key principles of supervisory review as under:

- Bank should have a process for accessing its overall capital adequacy in relation to its risk profile, as well as, a strategy for maintaining its capital levels.
- Supervisors expect banks to operate above the minimum regulatory capital ratios and ensure banks hold capital in excess of the minimum.
- Supervisory shall review bank, internal capital adequacy assessment and strategy, as well as compliance with regulatory capital ratios.
- Supervisors shall seek to intervene at an early stage to prevent capital from falling below prudent levels.

- **Market Discipline (Pillar III)**

Effective market discipline requires retable and timely information that enables counter parties to make well established risk assessment. Pillar

III relates to periodical disclosures to regulator, Board of Bank and market about various parameters which indicates the risk profile of the bank. Reserve Bank of India has stipulated that banks should provide all Pillar III disclosures, both quantitative and qualitative as at the end March each year along with the annual financial statement. The banks are required to put such disclosures on its websites. Market discipline promotes safety and soundness in banks and financial system and facilitates banks conducting their business in a safe, sound and efficient manner.

Challenges faced by Indian banking industry:

Developing countries like India, still has a huge number of people who do not have access to banking services due to scattered and fragmented locations. But if we talk about those people who are availing banking services, their expectations are raising as the level of services are increasing due to the emergence of Information Technology and competition. Since, foreign banks are playing in Indian market, the number of services offered has increased and banks have laid emphasis on meeting the customer expectations.

Now, the existing situation has created various challenges and opportunity for Indian Commercial Banks. In order to encounter the general scenario of banking industry we need to understand the challenges and opportunities lying with banking industry of India.

- **Rural Market**

Banking in India is generally fairly mature in terms of supply, product range and reach, even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region.

- **Management of Risks**

The growing competition increases the competitiveness among banks. But, existing global banking scenario is seriously posing threats for Indian banking industry. We have already witnessed the bankruptcy of some foreign banks.

- **Global Banking**

It is practically and fundamentally impossible for any nation to exclude itself from world economy. Therefore, for sustainable development, one has to adopt integration process in the form of liberalization and globalization as India spread the red carpet for foreign firms in 1991. The impact of globalization becomes challenges for the domestic enterprises as they are bound to compete with global players.

- **Financial Inclusion**

Financial inclusion has become a necessity in today's business environment. Whatever is produced by business houses, that has to be under the check from various perspectives like environmental concerns, corporate governance, social and ethical issues. Apart from it to bridge the gap between rich and poor, the poor people of the country should be given proper attention to improve their economic condition.

- **Social and Ethical Aspects**

There are some banks, which proactively undertake the responsibility to bear the social and ethical aspects of banking. This is a

challenge for commercial banks to consider the these aspects in their working. Apart from profit maximization, commercial banks are supposed to support those organizations, which have some social concerns.

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. 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.

Suggestions:

As per the above discussion, we can say that the biggest challenge for banking industry is to serve the mass market of India. Companies have shifted their focus from product to customer. The better we understand our customers, the more successful we will be in meeting their needs. In order to mitigate above mentioned challenges Indian banks must cut their cost of their services. Another aspect to encounter the challenges is product differentiation. Apart from traditional banking services, Indian banks must adopt some product innovation so that they can compete in gamut of competition. Technology up gradation is an inevitable aspect to face challenges.

The level of consumer awareness is significantly higher as compared to previous years. Now-a-days they need internet banking, mobile banking and ATM services.

Expansion of branch size in order to increase market share is another tool to combat competitors. Therefore, Indian nationalized and private sector banks must spread their wings towards global markets as some of them have already done it. Indian banks are trustworthy brands in Indian market; therefore, these banks must utilize their brand equity as it is a valuable asset for them.

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