RISK MANAGEMENT

The banks, in the process of financial intermediation, are confronted with various kinds of financial and non-financial risks, viz., **credit risk, interest rate risk, foreign exchange rate risk, liquidity risk, equity price risk, commodity price risk, legal risk, regulatory risk, reputation risk, operational risk**, etc.

- These risks are highly **inter-dependent/inter-dependent events that affect the banks/financial institution**s. One area of risk can have ramifications for a range of other risk categories.
- In view of this, the banks are **required to identify, measure, monitor and control the overall level of risks undertaken by them.**
- As the risks and risk management techniques for Small Finance Banks will be on par with the scheduled commercial banks, the extant **provisions in this regard as applicable to scheduled commercial banks, shall be applicable to SFBs** as well.

RISK MANAGEMENT FUNCTION

- Organizational structure
- Comprehensive **risk measurement approach**

- Risk management policies approved by the board, which should be consistent with the broader business strategies, capital strength, management expertise and overall willingness to assume risk
- Guidelines and other parameters **used to govern risk taking,** including detailed structure of prudential limits
- **Strong MIS for reporting, monitoring and controlling risks**
- Well laid out procedures, effective control and comprehensive risk reporting framework
- Separate risk management organization/framework independent of operational departments and with clear delineation of levels of responsibility for management of risk
- **Periodical review and evaluation**.

RISK MANAGEMENT STRUCTURE

- Each bank should **set risk limits after assessing its risks and the risk-bearing capacity.**

- At organizational level, the task of overall risk management is **assigned to an independent Risk Management Committee**.

- The purpose of this top-level committee is to empower one group **with full responsibility of evaluating overall risks faced by the bank** and **determining the level of risks which will be in the best interest of the bank**.

- The functions of Risk Management Committee are essentially to **identify, monitor and measure the risk profile of the bank.**

- The committee also develops policies and procedures, verifies the models that are **used for pricing complex products, reviews the risk models as development takes place in the markets and also identifies new risks**.

LOAN REVIEW MECHANISM (LRM)

- It is an effective tool for **constant evaluation of the quality of loan book** and for bringing about qualitative improvements in credit administration.

- Banks have used LRM 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.

- **Accurate and timely credit grading** is one of the basic components of an effective LRM.

TYPES OF RISKS IN A BANKING SYSTEM:

Credit Risk

- Credit risk is defined as the possibility of losses associated with diminution in the credit quality of the borrowers or counterparties.
- Credit risk emanates from a bank's dealings with an individual, corporate, bank, financial institution a sovereign.
- Credit risk may take the following forms:

a) **Direct lending:** Principal and/or interest amount may not be repaid.
b) **Guarantees or letters of credit:** Funds may not be forthcoming from the constituents upon crystallization of the liability.
c) **Treasury operations:** The payment or series of payments due from the counter parties under the respective contracts may not be forthcoming or ceases.
d) **Securities trading businesses:** Funds/securities settlement may not be affected.
e) **Cross-border exposure:** The availability and free transfer of foreign currency funds may either cease or restrictions may be imposed by the sovereign.

Market Risk

- market risk arising from adverse changes in market variables, such as **interest rate, foreign exchange rate, equity price and commodity price** has become relatively more important.
- Even a small change in market variables causes substantial changes in income and economic value of banks.
- Market risk takes the form of:

a) Liquidity risk
b) Interest rate risk
c) Foreign exchange rate (forex) risk
d) Commodity price risk
e) Equity price risk

Operational Risk

- The most important type of operational risk **involves breakdown in internal controls and corporate governance.**
- Such breakdown can lead to financial loss **through error, fraud, or failure to perform in a timely manner or cause the interest of the bank to be compromised.**
- 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 reputational risk.
- Legal risk includes, **but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.**

BASEL ACCORDS

- The Basel Committee on Banking Supervision (BCBS), is a committee of banking supervisory authorities that was **established by the central bank governors of a group of ten countries in the year 1985.**
- It consists of senior representatives of bank supervisory authorities and central banks from **Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States of America.**
- It usually meets at the **Bank for International Settlements (BIS)** in Basel (Switzerland), where its permanent secretariat is located.

Basel I Accord

- The BCBS first came out with **1988 Capital Accord for banks**, taking into account the elements of risk in various types of assets in the balance sheet as well as off-balance sheet business.
- Essentially, under the above system, **the balance sheet assets, non-funded items and other off-balance sheet exposures** are assigned

weights according to the prescribed risk weights and the banks have to maintain **unimpaired minimum capital funds equivalent to the prescribed ratio, on the aggregate of the risk weighted assets and other exposures, on an ongoing basis**.

Under the Basel I Accord, only the credit risk element was considered and the minimum requirement of capital funds was fixed **at 8% of the total risk weighted assets.**

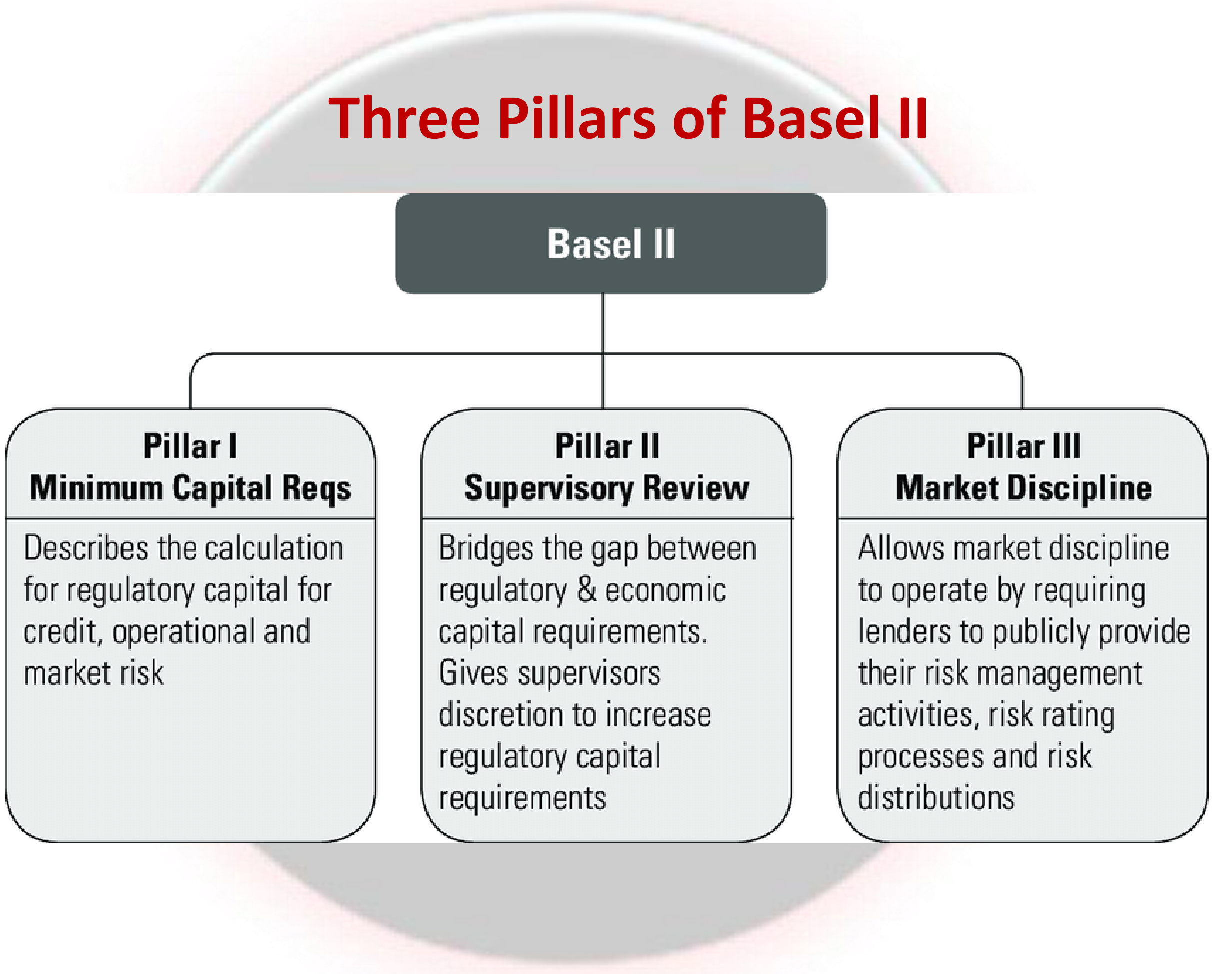
- Risk adjusted assets would mean weighted aggregate of funded and non-funded items.

In India, however, the banks are required to maintain a minimum Capital -To-Risk-Weighted Asset Ratio (CRAR) of 9% on an ongoing basis.

Basel II Accord

- BCBS brought out a report titled 'International Convergence of Capital Measurement and Capital Standards - A Revised Framework 2004 (also commonly called Basel Report II).
- Bank should maintain a minimum capital adequacy requirement of 8% of risk assets.
- **RBI follows 9% CAR Rule**
- Introduced in-**1999**

- Directives-**2003**
- Applied-**2006**
- Applied in India- **2009**
- **Fully implemented -2015**



There are 3 types of Risks:-

- Market risk
- Capital risk
- Operational risk

The First Pillar - Minimum Capital Requirements

The capital base of the bank consists of the following categories:

- Tier 1 Capital (going-concern capital)
  a) Common Equity Tier 1
  b) Additional Tier 1
- Tier 2 Capital (gone-concern capital)

From regulatory capital perspective, going-concern capital is the capital which can absorb losses without triggering bankruptcy of the bank. Gone-concern capital is the capital which will absorb losses only in a situation of liquidation of the bank.

The Second Pillar - Supervisory Review Process

This includes guidance relating I, among other things**, the treatment of interest rate risk in the banking book, credit risk (stress testing, definition of default, residual risk and credit concentration risk), operational risk, enhanced cross-border communication and cooperation and securitization.**

The Third Pillar - Market Discipline

Disclosure Requirements

- Supervisors have an array of measures that they can use to require banks to make such disclosures.
- Some of these disclosures will be the qualifying criteria for the use of particular methodologies or the recognition of particular instruments and transactions.

BASEL-III

- Basel III is only a continuation of effort initiated by the Basel Committee on Banking Supervision, to enhance the banking regulatory framework under Basel I and Basel II.

- This latest Accord now seeks to improve the **banking sector's ability to deal with financial and economic stress, improve risk management and strengthen the banks' transparency.**

- The Reserve Bank issued Guidelines based on the Basel III reforms on capital regulation on May 2, 2012, to the extent applicable to banks operating in India.

- The Basel III capital regulation has been implemented from April 1, 2013 in India, in phases, and it will be fully implemented as on March 31, 2019.

According to the norms, banks have to maintain a minimum common **equity ratio of 8% and total capital ratio of 11.5% by March 2019.**

Objectives/aims of the Basel-III

(a) Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source.

(b) Improve risk management and governance.

(c) Strengthen banks transparency and disclosures.

Key Principles of Basel III

1. Minimum Capital Requirements

The Basel III accord raised the minimum capital requirements for banks from 2% in Basel II to 4.5% of common equity, as a percentage of the bank’s risk-weighted assets

2. Leverage Ratio

Basel III introduced a non-risk-based leverage ratio to serve as a backstop to the risk-based capital requirements. Banks are required to hold a leverage ratio in excess of 3%.

3. Liquidity Requirements

Basel III introduced the usage of two liquidity ratios – **the Liquidity Coverage Ratio and the Net Stable Funding Ratio.** The Liquidity Coverage Ratio requires banks to hold sufficient highly liquid assets that can withstand a 30-day stressed funding scenario as specified by the supervisors. The Liquidity Coverage Ratio mandate was introduced in 2015 at only 60% of its stated requirements and is expected to increase by 10% each year till 2019 when it takes full effect.