



## STRUCTURED VIEW OF RISK MANAGEMENT IN BANKING INDUSTRY

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### 1. Introduction

Any financial institution is subject to risks during the execution of daily activities. The risk of errors in operations or incorrect payments, for example, may negatively impact the market's perception towards a bank, resulting in a loss of business and income, which may influence its long-term solvency. Risk management, therefore, is crucial to ensuring continued income generation and long-term solvency. Banking risks are significantly different from those of conventional business undertakings. This is largely due to the main trading activities of banks that relate to money and financial instruments as opposed to physical goods or commodities.

The Special nature of banking risks has absorbed many resources in attempts to recognize, define and manage it. Despite this, and notwithstanding the relative maturity of the banking industry, there is no universally accepted approach to the taxonomy of risk. The lack of a universal approach to risk classification has led to dissimilar and unrelated risks often being combined for the convenience of management and control.

### 2. Risk

Essinger and Rosen (2000:4) define risk as "... a measure of the anticipated difference between expectations and reality". This difference exists because the future is unknown, thus making it all the more important to manage risk.

Valsamakis *et al.* (2002:27) define risk "...as the presence of uncertainty, where there may be uncertainty as to the occurrence of an event producing a loss, and uncertainty as regards the outcome of the event..." Gitman (2000:237) defines risk in its most basic sense as the chance of financial loss. He also states that the term "risk" is used interchangeably with uncertainty to refer to the variability of  $\wedge$ returns associated with a given asset.

From the above definitions it is clear that risk evolves around uncertainty which might result in a loss to an organisation. Banks face a variety of risks that must be considered when servicing the needs of their customers. These needs include, for example, activities such as the provision of credit, acceptance of deposits, and the exchange of currencies on short notice, which enable customers to make the myriad payments necessitated by modern economic life (Falkena & Kok 2002:2). The flexibility that permits the provision of these services could cause uncertainty. In this sense banks must manage the risk, caused by the uncertainties surrounding it, to stay in business. Hence the importance of understanding the concept of risk management in the context of addressing uncertainty to prevent or reduce financial losses or adverse effects.

### 3.1. Risk Management

Taylor (1998:220) made the following statement, in emphasising the importance of understanding the term "risk management": "We clearly cannot eliminate risk, but we can manage it." Although Goldman *et al.* (2002:29) state that the term "risk management" does not have a universally agreed definition, they describe it as a reference to the complete set of policies and procedures which organizations have in place to manage, monitor and control their exposure to risk. In this sense Green (2002:45) states that risk management is a combination of procedures, systems and persons, used to control the potential losses of a financial institution. It also entails an activity to deal with changing environments that affect a bank's business. For example, a change in external factors, such as social, political or economic attitudes, may mean the emergence of new risk types, or more likely, changes in the weighting of importance that should be given to identified risk types.

Essinger and Rosen (2000:4) define risk management as an effective method for minimising the adverse effects of risk and maximising the benefits of incurring the risk. Adding to this viewpoint, Valsamakis *et al.* (2002:14) state that risk management is "...aimed at protecting the organisation, its people, assets, and profits, against consequences (adverse)...more particularly aimed at reducing the severity and variability of losses." Another definition of risk management is that of Dickson (2002:18) who defines it as the identification, analysis and economic control of those risks that threaten the assets or earning capacity of an organisation. Greene and Serbein (2004:3) define risk management as the process for conserving the earning power and assets of a firm by minimising the financial effect of accidental losses.

It is evident that risk management entails the control of risks facing an organisation and minimising the potential adverse effects of risk consequences. The focus of risk management, however, is dependent on and will change according to the nature of an organisation's business. For example, the latest developments in electronic banking may have a significant



influence on a bank's business and the accompanying risks that should be considered as part of the risk management responsibilities. The rapid pace of technological innovation is likely to change the nature and scope of the risks which a bank face, forcing the bank to introduce processes that will enable management to respond to the current risks and to adjust to new risks. As such, Goldman *et al.* (2002:39) emphasise the importance of effective risk research and mention that it constitutes a significant part of risk management. \*

According to the Basel Committee (2002a:10), a risk management process, that includes the basic elements of assessing risks, controlling risk exposure and monitoring risks, will enable banks to respond to these challenges. It is therefore imperative to establish an integrated approach to risk management that forms the basis for the management of all the risk types.

### 3.2 Integrated Approach to Risk Management

As organisations encounter new types of risk while pursuing new business objectives, they need an integrated risk management framework for a holistic approach to risk management. Banks, for example, have increasingly become exposed to compliance and regulatory risk as they have expanded their business. Credit risk, for example, has become more of an issue, as banks became more involved in trading over-the-counter derivatives. In addition, as banks became more heavily involved in trading activities, market risk has also become an important concern. It is clear, therefore, that an effective risk management function, which is based on a firm-wide and integrated framework, is necessary to ensure that all the risks are covered.

Schwartz and Smith (2000:410) identify a number of major trends and developments that confirm the need for an integrated risk management approach. These trends are the following:

- Globalisation and integration of financial markets have broken down the boundaries between countries and established a closer bond between international markets and economies. Thus, financial institutions with international investments and operations need to manage global risks on an integrated basis.
- Financial and derivative products involve various risk types, for example, credit, interest-rate and market risk, which highlights the need for an integrated approach to risk management.
- Technological developments and the dependency on computer systems also attribute to a wider risk exposure and the need for an integrated approach to risk management.

The above trends and developments have increased the complexity of risk management because risks can easily be transferred from one to another, for example market risk to credit risk, and they can also roam across counterparties, industries, markets, and countries (Schwartz & Smith 2000:411). It is thus clear that financial institutions need an integrated risk management approach.

However, to establish an integrated risk management approach, it is necessary to ensure the effectiveness of the components of an integrated risk management framework. Schwartz and Smith (2000:411) classify these components as follows:

- Organizational effectiveness;
- Risk performance management; and
- Systems technology.

### 3.3 Organisational Effectiveness

Schwartz and Smith (2000:411) state that the overall risk management framework is underpinned by three fundamental aspects of the organisation, namely:

- *Business strategy* which defines how the organisation will compete in target business segments;
- *Organisational structure and people* that provide management direction and control for business and risk management activities; and
- *Incentive compensation system* which provides rewards for key personnel.

**Business Strategy** - If an organisation's strategy take risk into account, the organisation could increase its effectiveness of risk management by, for example, integrating risk management controls into their business processes and operations (Freeman 2002:16). Venkat (2000:589) adds that institutions can enhance the overall effectiveness of risk management by closely linking it to business strategy formulation. This can be accomplished by proactively acknowledging and incorporating risk management considerations into business decisions regarding, for example, new ventures, products, trading strategies, and customer initiatives. The involvement, for example, of risk managers in developing business strategies and formulating relationships or product plans, ensures that business initiatives are consistent with risk management policies. Organisations that have a successful integrated business strategy and risk management process are proactive in defining markets that should



be targeted and the risks they should accept or mitigate. From a strategic perspective, these organisations are better positioned to achieve a balance between originating business and managing risk (Schwartz & Smith 2000:411-412).

**Organisational Structure.** An organisational structure must be in place to facilitate communication about risk and to enforce the stature and clout the risk management team must have within the institution (Freeman 2004:15). A typical traditional organisation structure and risk management responsibility for a financial institution is shown in figure 2.1. This structure is based on functional areas and is often ineffective in managing risk as much risk is multi-dimensional and interrelates. Therefore various types of risk should not be segregated and managed by separate functions or departments. Schwartz and Smith (2000:415) indicate that most financial institutions have already initiated efforts to centralise risk functions that deal with all aspects of financial risk including credit, market, liquidity, technology and operational risk. To manage all risks on an integrated basis, this centralised risk management function has the following key responsibilities (Schwartz & Smith 2000:416):

- Establish risk management policies and procedures and reporting requirements.
- Coordinate or direct daily risk management activities.
- Measure global risks on a consistent and integrated basis and monitor development that may impact the organisation's exposures.
- Review and approve risk management methodologies and models.
- Work with the audit and compliance functions to ensure that business activities comply with laws, regulations and internal policies and procedures.
- Communicate risk management results to executive management and the board of directors.

**Incentive Compensation System** - Freeman (2004:17) states that the creation of a fair payment scheme for employees poses a major challenge and is a critical element of risk management. An organisation may have all the risk management tools, processes and systems in place, but without motivated personnel these would be useless. Schwartz and Smith (2000:416) mention that if incentive compensation is a key driver of human behavior then, by extension, it is also a key driver of risk management. The effectiveness of a financial institution in managing its risks is thus ultimately dependent on the collective decisions made and actions taken by its people. Hence, the importance of an effective incentive scheme to ensure a motivated workforce and that the right people are placed in the right positions.

### 3.4 Risk Performance Management

The core objective of any performance measurement system is to establish a benchmark that could be used to evaluate the economic return of business activities. Schwartz and Smith (2000:418) state that the key to measuring the risk performance of a business activity is to clearly establish a link between risk and return. Gitman (2000:239) describes return as the gain or loss experienced on an investment over a given period of time. He also states that there are three basic risk preference behaviors, which could be used to determine the link between risk and return, namely:

- *Risk-indifferent.* The attitude towards risk that requires no changes in return for an increase in risk.
- *Risk-averse.* The attitude towards risk that requires an increase in return for an increase in risk.
- *Risk-seeking.* The attitude towards risk whereby a decreased return would be accepted for an increase in risk.

Most managers tend to be risk-averse. Thus, before management accepts an increase in risk, they would require an improvement of performance that would increase return. However, in the modern banking industry it sometimes requires from management to take a risk-seeking approach towards risk to ensure a competitive edge over their rivals and a positive growth in business.

### 3.5 Systems Technology

An integrated risk management system should tie all the risk-generating factors together across the entire range of the financial institution's activities. An integrated systems environment is therefore a key component of an integrated risk management framework because the output, such as reports and graphics, is imperative to support the measuring and managing of risk.

According to Williams (2000a:614), risk management needs technology that will allow information to be drawn from all levels within the organisation. She (2000a:634) also states that an institution's ability to manage risk will determine its competitive advantage. This ability is, however, highly dependent on technology. Therefore, an institution's ability to plan, create, implement and maintain risk information technology (IT) is regarded as a core competency.



#### 4.1 Risk Management Process

Venkat (2000:592) is of the opinion that as financial institutions come under increasing pressure to improve shareholder value, they need to consider a business and risk management model that goes beyond merely measuring, monitoring and reporting risk. A model, which links the business mission and strategies to execution and to the elements of the risk management infrastructure, is required. An integrated approach to managing risk ensures full identification and awareness of significant risks, consistent risk measures and proper management controls, thus addressing the above-mentioned concerns. However, this integrated approach needs to be managed to ensure the effectiveness of risk management as well as the continued profitability and viability of a bank. This could be achieved by following a formal risk management process.

Venkat (2000:592) describes a risk management process as a structured cycle of control activities that provides management with assurance that all risks within the institution are being effectively managed. Although every institution will have its own unique approach to this process, depending on the potential effect of risk on its business, it is a process of identifying exposures to risk, choosing the best method of handling each exposure and implementing it accordingly (Kreitner *et al.* 2002:606-608). This, according to Kieitner *et al.* (2002:608), usually leaves the risk manager with four basic alternatives from which to choose when deciding how to manage risk, namely:

- *Risk avoidance.* An activity that may lead to risk exposure is identified and subsequently avoided. For example, in the 1980s many companies decided not to extend their operations to South Africa in order to avoid the risk of the political instability.
- *Risk assumption.* A specific risk is identified and accepted as part of daily activities. This usually is the case when the odds are strongly against an event happening or when the potential loss is low.
- *Risk transfer.* Risk exposure is identified and is subsequently transferred to a third party who is prepared to take the risk, for example, insurance companies. When an insurance company agrees to pay the losses of an insured, the risk faced by the insured is transferred.
- *Risk reduction.* The lessening of the uncertainty of a loss in a risky situation. For example, many companies go to great lengths to promote worker safety to avoid not only the financial costs of injury, but also the down time and disruption of work that would accompany it. Risk reduction can be achieved in different ways, for example, hazard reduction and loss reduction. Hazard reduction involves reducing the odds that a loss will occur and loss reduction involves reducing the severity of the loss.

Although the above points refer to alternatives on *how* to manage risk exposure, they do not indicate specific steps within a risk management process. It is usually up to the management of an organisation to determine and implement a risk management process which will be appropriate to their specific business. However, there are various viewpoints about the elements that should be included in such a risk management process.

#### 4.2 Elements of a Risk Management Process

The elements of a risk management process, namely risk identification, risk evaluation, risk control, and risk financing were identified in the preceding section and will now be discussed in detail.

##### 4.2.1 Risk Identification

Risk identification could be seen as the starting point of the risk management process. It is important that management realises that as a business grows, expands or improves, the exposure to risk will also change. Hence the importance of risk identification in the risk management process which obviously filters down to the other elements of the process.

The Financial and Management Accounting Committee (FMAC) (2004:13) states that risk is most often used in three distinct senses, namely risk as an opportunity, risk as a hazard or threat and risk as uncertainty. The above distinction could assist in the identification process, as well as in the management of the other elements of the process.

- *Risk as an opportunity.* Risk, as an opportunity is, according to the FMAC (2004:13), implicit in the concept that a relationship exists between risk and return. The greater the risk, the greater the potential return and the greater the potential for a loss. In this regard, the risk should be managed by using techniques to maximise the upside within the constraints of the organisation's operating environment and minimising the downside of the risk.
- *Risk as a hazard or threat.* Risk as a hazard or threat usually refers to potential negative events (downside) such as financial loss, fraud, theft, damage to reputation, injury or death, systems failure or a lawsuit. In this regard, the management of the risk should include the positioning of management techniques to reduce the probability of the negative event without incurring excessive costs or paralysing the organisation. Valsamakis *et al.* (2002:39) define hazard as relating to the environment surrounding the cause of loss.
- *Risk as an uncertainty.* According to the FMAC (2004:14), risk as an uncertainty refers to the distribution of all possible outcomes being negative or positive. In this context, risk management seeks to reduce the variance between anticipated outcomes and actual results.



#### 4.2.2 Risk Evaluation

Once risks have been identified, they should be evaluated. Valsamakis *et al.* (2002:104) define risk evaluation as the appraisal, the assessment or the finding of the numerical expression of risk. Risk evaluation thus entails the quantification of the risk and determining its possible impact on an organisation (Valsamakis *et al.* 2000:26). According to Head (2000:50), the process of risk evaluation is the analysis of loss exposure, where attention is focused on how frequent and how severe accidents are likely to be and how they may interfere with the organisation's success. Valsamakis *et al.* (2000:26) also state that risk evaluation and assessment concern the following:

- The evaluation of both loss frequency and loss severity - an analysis that will provide, *inter alia*, the two significant measures of expected average loss and maximum possible loss.
- An analysis of the financial strength of the organisation which entails the assessment of the firm's risk potential capacity. The objective is to ascertain what the impact of a given risk might be relative to the financial strength of the firm.

#### 4.2.3 Risk Control

Having performed a risk assessment, a bank's management should take steps to manage and control the risks it faces. Valsamakis *et al.* (2002:120) define risk control as methods of countering risk. In a broader sense it includes, firstly, all activities conducted for the purpose of eliminating or reducing the factors that may cause loss to the organisation. Secondly, it minimises the loss that occurs when preventative methods have not been fully effective. Risk control can thus be seen as an activity to mitigate risk.

It is evident that effective risk control requires a well-supported risk management programme. The programme should be governed by a clearly defined risk management strategy which, in turn, should be consistent with business strategies and objectives. Katz (2003:161) states that these controls (programmes) need to be established for that risk it intends to manage. The Basel Committee (2002c:11) states that having made an assessment of risks, bank management should take steps to manage and control these risks. This phase of the risk management process could include activities such as implementing policies and procedures, internal controls, risk reporting and decision-making, as well as, determining an organisational structure to form the basis of the process.

Venkat (2000:587) states that an effective risk management framework balances the infrastructure- aspects of risk management, such as, roles, responsibilities, \*accountabilities, policies, methodologies, controls and information tools, with the more qualitative aspects of risk management, such as, philosophy, culture, training, awareness, and appropriate behavioral reinforcement. He (2000:594) states that the risk management infrastructure forms the foundation for the risk management framework. It provides the organisational, analytic, operational, and system(s) support for effectively executing the risk management process and consists of the following:

- A central and independent risk management unit with clearly defined roles and participation in the strategic decision-making process.
- Formulated policies and procedures that clearly define and communicate the risk management process.
- Consistent methodologies for risk measurement that capture the potential for losses, foregone opportunities and risk diversification effects across different risk categories.
- Limit structures that Set maximum tolerances in relation to capital and the firm's risk-taking philosophy.
- Comprehensive management reports that communicate risk on a periodic basis.
- Information technology to satisfy risk information needs throughout the organization.

#### 4.2.4 Risk Financing

According to Ritchie and Marshall (2003:245), risk management may be seen as part of the organisation's general financial planning and control activity. Thus when managing risk, the cost of risk, as the final step of a risk management process, is an important issue to consider. Valsamakis *et al.* (2002:243) state that through systematic identification, evaluation and control, the severity and frequency of losses can be reduced. The risk management process, however, must also include the element of financing. They also argue that risk financing becomes visible when consideration is given to the pursuit of minimising the total cost of risk to an organisation.

A risk management process should be cost effective and expenditure should be to the benefit of the organisation. Hence, the cost of risk should reflect cost-efficiency and ensure optimal financing. Valsamakis *et al.* (2002:244) define the cost-of-risk as the sum of:

- net insurance premiums;
- unreimbursed losses;





- risk control and loss prevention expenses; and
- administration costs.

The basic concept of risk financing is to ensure that the cost of risk and of the risk management process do not exceed the potential benefits they have for the organisation. A risk management process can therefore require a pre-financing or post-financing policy. The risk type plays an important role in dictating the risk financing policy. An example of a pre-financing policy is financing by means of insurance and self-funding, while post-financing could consist of cash resources, debt and equity finance (Vaisamakis *et al.* 2002:249).

The writer is of the opinion that the management of every risk type must be subject to a financial evaluation process to determine its contribution towards the overall effectiveness and profitability of an organisation by comparing its cost to benefits. During the discussion of the risk management process it is evident that the identified model could be used generically for all risk types. However, the methodologies for measuring, evaluating, controlling and financing risk types may differ radically according to the risk type. To be able to distinguish between the risk types and to determine the approach to and views of operational risk, it is necessary to discuss the classification of risks. This is the focus of the next section.

## 5. Summary

Firstly, risk, as the overarching concept, is viewed as the possibility of incurring misfortune or loss, which, if not effectively managed, might result in adverse effects for the organisation. Subsequently, managing the risks, is indicated as the control thereof and the minimising of the potential adverse effects of the risk consequences. An integrated approach to risk management became evident, based on trends such as the globalisation and integration of financial markets, derivative products, which involve various risk types, and technology developments. To establish an integrated risk management approach, it is necessary to ensure the effectiveness of the components of an integrated risk management framework, which are classified as organisational effectiveness, risk performance management and systems technology.

Thirdly, the risk management process consists of various elements, as seen by different authors. Notwithstanding differences in opinions by these authors, a holistic view on the classification of elements for a risk management process was identified, namely:

- Risk identification.
- Risk evaluation.
- Risk control.
- Risk finance.

After a brief overview of the elements of a risk management process, risk classification was discussed. The general approach is to group risks into main categories of risk types. It is evident that there does not exist a general agreed classification amongst different authors, but it is clear that for an organisation to effectively manage its risks, risk types must be clearly understood and formulated according to the business of the organisation. Although some authors differ as to the content of operational risk, most of them regard it as a main risk type, which led to focussing on an overview of operational risk. Various definitions and approaches of operational risk were identified, in order to determine the most common underlying operational risk factors that should be addressed when formulating an acceptable definition for operational risk.

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