

# Conceptualising The Panorama of Risk Management In Indian Banking Sector

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## Abstract

In today's globalised era, risk is inherent in any business activity. Due to cut throat competition, organizations across all domains encounter various types of challenge, thereby making themselves more risk prone and necessitating the requirement of sound risk management system. Banking industry, the backbone of any country's financial system is susceptible to diverse upheavals by virtue of its nature of business. This paper is an attempt to discuss the stated patterns in the area of risk management in banking. It also tries to demystify the underlying dimensions in the study of risk management, along with throwing some light on the policies undertaken in Indian context.

## Keywords:

Banking Sector, Risk Management, India.

## Introduction

The practice of risk management is an age old phenomenon. With the passage of time almost all the economies are changing at a very fast pace, so as their regulation regarding financial institutions, thereby making them more independent in decision making. The traditional concept of doing business by staying under well guided regulations and stereotypical thinking no longer exists, which is bringing fresh air for the market but at the same time increases the extent of volatility. Thus modern financial institutions are more exposed to risk than before. Economic records exhibit instances of financial flux across the world, which in turn recognize the need for entrenched risk management system especially for the financial institutions. According to Leeladhar (2007), the opening up of economy has witnessed various new windows, new banks, new instruments, new opportunities, and above all new challenges. As a result, managing risk is the first step towards sustaining profitability in case of any financial institution.

According to Pyle (1997), Risk management is the process of identifying 'key' risk, obtaining consistent, understandable and operational risk measures, choosing which risk to reduce and which to

increase and by what means and establishing procedures to monitor the resulting risk position. Banking is the backbone of any financial system. The strength of economy of any country basically hinges on the strength and efficiency of the financial system, which, in turn, depends on a sound banking system (Pathak, 2008). More than any other business entities, banks are extremely interconnected to each other, which can lead to a domino effect in times of trouble (Mukhlynina & Nyborg, 2012). Hence, to maintain the momentum of growth of the economic system of a country, banking sector are to be managed efficiently so as to respond to changing times. An extremely healthy and prudent banking sector has the ability to withstand risk and shock of the financial system and ensure overall financial stability (RBI, 2011). This paper is an attempt to accentuate the concept, historical background of risk management and further the studies conducted across nations with respect to Banking risk management. The study will also try to discuss the available international as well as domestic policies in this context.

### Objectives of The Study

The basic objective of this paper is to provide an overview of risk management in Banking along with adoption procedure in the light of surveyed literature. The specific objectives are mentioned below-

- i) To map out the concept of risk, risk management from historical perspective.
- ii) To comprehend the various dimensions of studies conducted on Risk management in banking industry.
- iii) To have a glance of policies undertaken to contain risk in India.

### Conceptual Framework of Risk & Risk Management

The etymology of the word "Risk" can be traced to the Latin word "**Rescum**" meaning '**Risk at Sea or that which cuts**' (Raghavan, 2003). The common meaning of the word is uncertainty. The very word 'Risk' is associated with every walk of business life. Risks are generally understood to be the uncertainties related to the outcomes (in terms of revenue and profits, for example). But Mu(2007) elucidated a fine line of difference between the two terms 'Risk' and 'Uncertainty' by means of classifying unquantifiable risk as 'uncertainty' and using the term 'risk' particularly for quantifiable risk.

Risk is an exposure to a transaction with loss, which occurs with some probability and which can be expected, measured and minimized (Goyal & Agarwal, 2010). Risk is the potential variation in outcomes (Williams et al., 1998). Raghavan, 2003 holds that risks are inter-dependent and events affecting one area of risk can have ramifications and penetrations for a range of other categories of risks as well.

Managing risks was for a long time considered to be beyond the power of mankind and only in the hands of the gods. According to Porthin 2004, one form of Risk Management, insurances, has been practiced for thousands of years. From mid 17<sup>th</sup> to mid 18<sup>th</sup> century, the concept of probability and its primary properties, the main foundations in risk management, were developed (Bernstein, 1996). Modern risk management started evolving after the Second World War on two different fields: insurance buying as well as reliability and safety engineering. These fields grew side by side for decades with very little interaction (Williams et al., 1998). Porthin (2004) points out that today risk management in the financial field is mainly concerned with reducing undesired uncertainty. A current challenge is to study all risk factors in an organization as a whole and manage those using suitable methods from all available fields (Raikkonen, 2002; Raikkonen and Rouhiainen, 2003).

The systematic process of identifying, evaluating, and reducing risks is usually referred to as risk management (Porthin, 2004). Risk management is described as the performance of activities designed to minimize the negative impact (cost) of uncertainty (risk) regarding possible losses (Schmidt and Roth, 1990). The basic objective of risk management in the context of finance is to ensure liquidity and long term solvency of the organization. Goyal (2010) articulated that the process of risk management comprises the functions like: Risk identification, Risk measurement/quantification, Risk control and Risk monitoring.

### Banking and Risk Management

Banking is the backbone of any financial system. Banking, by its nature, entails a wide array of risks (Basle Committee on banking Supervision, Sept.1997). By virtue of its business, banks are exposed to risks which can be Systematic as well as Unsystematic risks. Systematic risk is caused by the changes in the market variables like fluctuation in the interest rate, foreign exchange rate, equity price, and commodity price etc. while unsystematic risk may arise out of abnormal events like economic crisis, wildcat strike and so on. Banks across the globe assumes risk as risk is pre-requisite for survival. Banks as well the Central banks must foresee the risks and act accordingly so as to balance the same.

The implementation of risk management is not an answer to risk, rather it implies an organizational system which involves changes in the way the banking institution organizes, assigns responsibilities, and approaches the risk management as a key competence, continuously and in due time implements the risk management. Indian financial system is deeply intertwined to the existing banks irrespective of nature and ownership, in maintaining overall financial stability (RBI, 2011). Any disruption will bring

catastrophe in the entire. There are powerful motives to implement risk based practices to provide a balanced view of risk and return from a management point of view; to develop competitive advantages, to comply with increasingly stringent regulations (Arora & Agarwal, 2009). Reserve bank of India is also concerned about a more stringent risk management system in Banks responding to the changing scenario. In recent years, however, risk management has emerged as a central issue especially for financial institutions.

### Methodology of The Study

The study is the result of extensive search of literature in the related field. The study has focused on highlighting the research conducted so far in the field of risk management in the context of banking Industry. Using a descriptive approach the study is an attempt to represent the various findings related only on the basic concept of risk management and the various methodologies applied so far to deal with the concept. The studies referred for this particular objective are grouped by the objectives as well as methodologies adopted.

### Review of Literature

#### Studies Conducted in Abroad

Following are some of the studies conducted outside India in the context of Risk management in Banking-

Santomero(1996) in his well acclaimed work 'Commercial bank risk management: an analysis of the process' has outlined the types of risk, the state of risk management techniques in the banking industry of North America and identified four consecutive steps to manage basic risk. He also explains using descriptive approach how these techniques are applied to deal with the basic risks. Nicolae and Teodora, in their paper 'Study on the risk management in Banking Institutions' has tried to identify the major risks faced by Romanian banks and the suitable measures to counter them by collecting customers and bank managers views by conducting a survey among them.

Manta (2009) in his thesis titled 'Risk management in Banking' has focused on the general risk assessment at the banking system and then studied the banking risk management practice at SC Bancpost. Shafiq and Nasr(2010) in their study 'Risk management practices followed by commercial banks in Pakistan' has tried to explore the risk management practices being followed by the commercial banks in Pakistan based on primary data. Secondary data for the period 2000-2008 were collected and used to link the risk weighted Capital Adequacy Ratio (CRAR) to the different financial indicators like Capital Adequacy Ratio, Asset quality, Earning and Liquidity of the commercial banks that are used to measure their soundness. As the study was more or less generalized in nature they have stressed on the need for the study of specific risks. Awojobi and Amel (2011) in their study 'Analysing Risk Management in Banks: Evidence of Bank Efficiency and Macroeconomic Impact' have tried to identify the factors which affect the efficiency of risk management (treated as Capital Adequacy Ratio) in Nigerian banks. They used time series data for 2003-2009 with respect to bank specific variables like profitability, credit exposure etc., and macroeconomic variables like GDP growth and inflation rate and so on. Anderson, in his research work 'A study of risk management in the United Arab Emirates banking system' has used primary data to identify the main risks as well as how the Basel II agreement has impacted on risk management in the banks and the extent it has either helped or hindered. He further focused on understanding the degree to which bank staff in the UAE understand the nature of risk and the attitude that they take towards risks and risk management. Elsinger, Lehar and Summer in the study 'Risk assessment for banking systems' tried to appraise the financial stability of an entire banking system using standard tools from modern risk management in combination with a network model of inter-bank loans. Rather than looking at banks individually, they analyzed risk at the level of the banking system as a whole in case of Austrian banks.

**Classification by Objectives of Study**

Name of the author	Name of the article	Source of article	Year of Publication	Findings by Objective
Santomero	Commercial bank risk management: an analysis of the process	Wharton working Paper	1996	Identification of basic risks, state of risk management techniques in the banking industry of North America
Oldfield& Santomero	The Place of Risk Management in Financial Institutions	Wharton working Paper	1997	Exploration of the role of risk management in financial Institutions and to achieve the highest value added from risk management

Nicolae & Teodora	Study on the risk management in Banking Institutions	IDEAS: Studies in business and economics		Identification of basic risks in Romanian banks and suggested measures to counter them
Manta	Risk management in Banking	Thesis	2009	Assessment of general risk and study of risk management practices in a single bank
Shafiq and Nasr	Risk management practices followed by commercial banks in Pakistan	International Review of Business Research Papers,	2010	Exploration of the risk management practices being followed by the commercial banks in Pakistan without focusing on any specific risk.
Awojobi and Amel	Analysing Risk Management in Banks: Evidence of Bank Efficiency and Macroeconomic Impact	Journal of Money, Investment and Banking	2011	Identification of the factors affecting efficiency of risk management in Nigerian banks.
Kanchu & Kumar	Risk management in banking sector - an empirical study	International Journal of Marketing, Financial Services & Management Research	2013	Identification of the risks faced by the banking industry and trace out the process and system of risk management. Also examine the techniques adopted by banking industry for risk management.
Elsinger, Lehar & Summer	Risk Assessment for Banking Systems	Emerald Management Review	2006	Analysis of Financial stability of entire banking system in the light of modern risk management
Li	Determinants of Banks Profitability and its implication on Risk Management Practices: Panel Evidence from the UK in the Period 1999-2006	Dissertation report in university of Nottingham	2007	Examining impact of bank profitability on risk management
Rosman	Risk Management Practices and Risk Management Processes of Islamic Banks: A Proposed Framework	International Review of Business Research Papers	2009	Suggesting conceptual framework and relationships between risk management practices
Danielsson, Jorgensen & Vries	Incentives for Effective Risk Management	Journal of banking and finance	2002	Compare the risk based management systems and their efficacy.
Goyal and Agarwal	Risk management in Indian banks	IJER	2010	
Raghavan	Risk Management in Banks	Chartered Accountant	2003	Identification of category of risk and risk management.
Arora & Agarwal	Banking risk management in India and RBI supervision		2009	Examination of risk management practices of RBI taking the case of some selected banks.
Kaur	Credit Risk Management and Resilience of Indian Banking Sector	Journal on Banking, Financial Services & Insurance Research	2011	Identification of types of risk and common approaches adopted by banks to manage the same.



Balu	Risk Management and Its Impact on Financial and Banking Activity	Doctoral Thesis	2009	Presenting an overview of risk, highlighting the importance of risk management for financial institutions and the need for its improvement in the context of the global current financial crisis
Rao	Risk Management Architecture - A Cross Comparison Between Select Indian And Foreign Banks - Impact Of Risk Based Supervision	Doctoral Thesis	2011	Presenting overview of Indian financial system and the risk management system in the light of Basel1 and 2. Also to compare public sector banks with private sector banks and to rank some selected banks based upon some specific parameters.

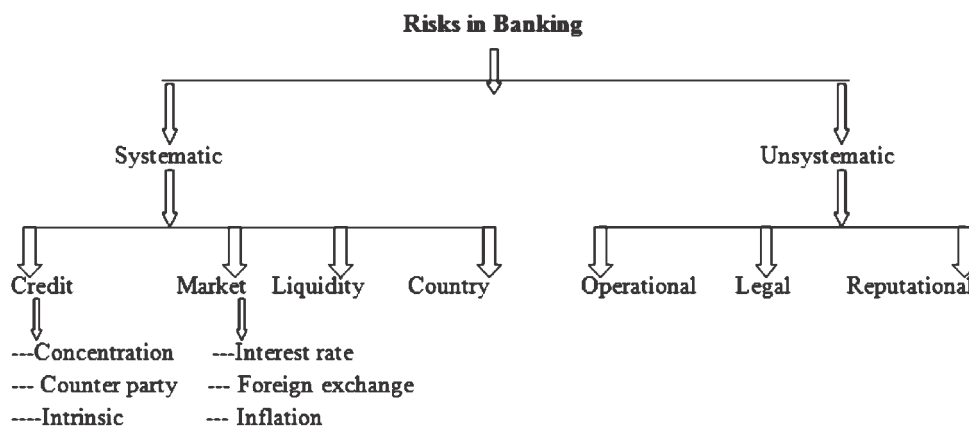
#### Classification by Methodology of Study

Name of the authors	No. of Publication	Methodology adopted
Santomero, Raghavan, Kaur, Arora & Agarwal, Goyal & Agarwal, Rosman, Kanchu & Kumar	7	Theoretical assessment of the concept of risk, processes of risk management and detail overview. Exploratory research design is mostly followed to figure out the problem.
Nicolae & Teodora, Manta, Shafiq and Nasr	3	Using primary data and following descriptive research tried to assess the risk.
Balu	1	Using various models tried to assess the impact of various risks in banks. Econometric model, Value at Risk methodology for risk measurement, one model based on duration gap methodology and developing some empirical models in line with Basel II
Elsinger, Lehar & Summer	1	Using Network model of Interbank market in Austria tried to assess the level of risk faced by the sector as a whole
Danielsson, Jorgensen & Vries	1	Comparison between the direct risk monitoring and indirect risk monitoring
Awojobi and Amel	1	Using Panel regression method and descriptive research design tried to figure out the variables affecting risk management.
Li	1	Using deductive approach, forming empirical model and applying regression tried to assess the impact of bank specific factors and macroeconomic factors on bank's profitability, which was measured by return on average assets

#### Summary of Studies conducted

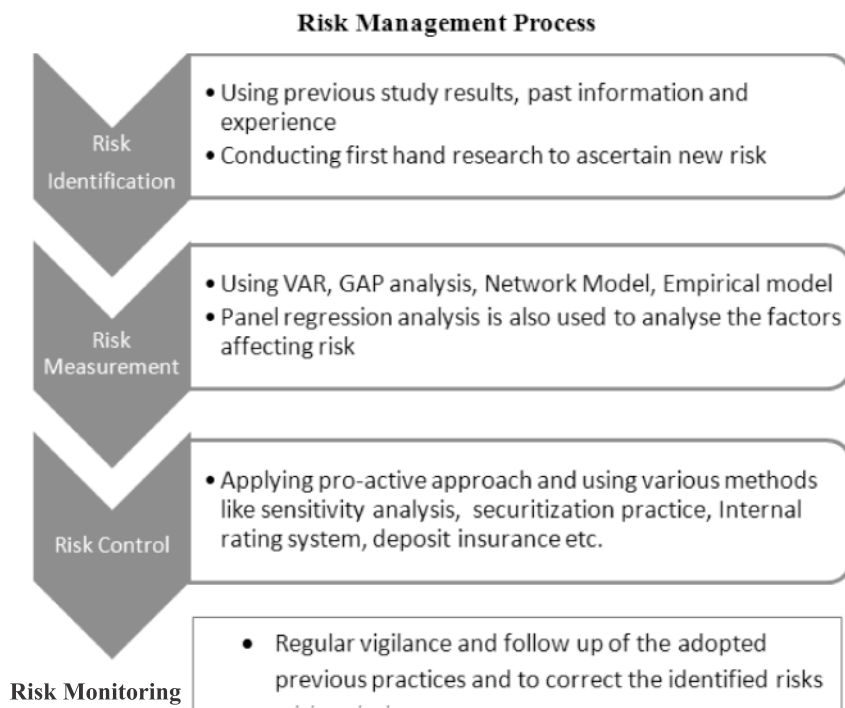
Summing up the referred literature, it is quite evident that most of the studies started with categorizing various risks

prevalent in banking industry across the globe. These are represented by the following chart-



**Chart-1:** Prepared by author

Also if we try to evaluate risk management process in the light of surveyed studies, the following chart emerges-



The aforesaid studies, although in several cases tries to put forth the basic idea about the diverse risks faced by the banks across the globe, they reveal some important findings as well:

1. There is a need to focus on specific risk on a case to case basis instead of analyzing summated risks and to identify the most crucial one as it can have compounding negative effect upon the banking fraternity.
2. Further there is scope for analyzing the risk matrix among

all public, private, and foreign banks under operation.

3. There is a necessity of studying risk management in the light of Basel II & III recommendations to check the suitability and efficiency of adopted approaches.
4. Also there is a need to appraise the overall profile of financial stability of banking sector in a country in the light of risk management practices.

Taking a cue from the above eye-opener studies, an attempt

has been made to identify the policy measures adopted in India with respect to Risk management. While revisiting the policy framework it has emerged that major thrust has been given to manage credit risk as it is treated as the critical one. Following review is undertaken to make the picture clear.

### Review of Existing Policy Framework Undertaken in India to Counter Credit Risk

In India, risk management was not a point of concern before the liberalized regime. But with financial sector reform as well as with the stipulation laid down by Basel committee for banking supervision, with a view to harmonize the

process of banking supervision in the international level several measures were taken.

After liberalization and opening up of Indian economy, an immediate reform in the financial sector was impending. Hence, Govt. of India appointed Narasimham committee in August, 1991 which submitted its report in Nov. 1991 with recommendation of Market Oriented transformation of Indian banking. Since January, 1992 RBI started implementing the policies taking into account the committee recommendations. Here an attempt is made to list the chronological sequence of various policies undertaken by RBI to counter Credit Risk of commercial banks.

**Credit Risk of commercial banks.**

Sl No.	Policy initiated on	Policy initiated by	Major thrust of the policy
1.	1992	RBI	New guidelines on IRAC and provisioning requirements were issued.
2.	April 1992	RBI	Risk asset ratio system for banks as Capital Adequacy Ratio measure.
3.	1993	RBI	Asset classification norms were redefined. Since 31 <sup>st</sup> March, 1993 all advances irrespective of their outstanding, were classified as Standard Assets, Sub - std. Assets, Doubtful Assets, and Loss Assets.
4.	March, 1993	RBI	The norms for declaration of NPA accounts were tightened.
5.	August, 1993	RBI	For recovering the banks dues, 'The recovery of Debts due to banks and Financial Institutions Act, 1993' was passed on 27 <sup>th</sup> August.
6.	April, 1994	RBI	A scheme was introduced for collection and Dissemination of information on cases of defaulters whose outstanding balance is Rs. 1 crore and above.
7.	January, 1998	RBI	Banks were instructed to disclose Capital Adequacy Ratio (Tier 1&2 capital) as a part of mandatory disclosure. Henceforth, banks were maintaining minimum of 8% CRAR.
8.	2000	RBI	Minimum Capital to Risk -weighted Assets ratio (CRAR) was increased to 9%.
9.	2000	GOI& SIDBI	CGTMSE, a credit guarantee fund trust was established to encourage commercial banks to move away from a Security oriented approach and provide collateral free credit facility for Micro and Small Enterprises.
10.	2002		SARFAESI Act was passed for faster resolution of Stressed Assets. It was effective since 21 <sup>st</sup> June, 2002.
11.	October, 2002	RBI	Credit risk management framework for banks was issued
12.	28 <sup>th</sup> Feb, 2005	RBI	3 Asset Reconstruction Companies were given the license to be formed in India.
13.	2006	SBI& HDFC	CIBIL, the first of its kind in India was formed to provide credit information to Banks.
14.	2006	RBI	BCSBI was set up and it gave the 'code of bank's commitment to customers'
15.	2011	RBI	SARSEI was formed and all SCBs are now required to incorporate all the security information in the Registry and consult it before taking up any new security.

## Conclusion

The study points out some of the phenomenal changes that took place in Indian banking sector over the years. The above review suggests that there are stringent laws and policy measures at par with international guidelines have already been adopted in India. The question of identifying lacunae in these aforesaid policies needs to be envisaged.

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