Volume-5, Issue-9, September- 2016 • ISSN No 2277 - 8160 IF : 3.62 | IC Value 70.36

Original Research Paper Commerce

Future and Challenges of Information Security & Operational Risks in Payment Banks

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ABSTRACT *Payment Banks are the recent innovation echoing the thoughts bankers have constantly endeavored - to develop new products which are suitable for everyone. On 19th Aug 2015, the RBI announced 11 approvals for Payment Banks, a stripped down version of a full service bank which is designed to reach people outside the span of formal banking services. In the present highly competitive banking; which demands evolving strategies to promote interest of all stakeholders, the need to cut costs in its product & services; how are they going to optimize the Operational Risk processes mandated for opening new full-service bank's structure? The solution therefore has been to incorporate processes through diverse set of tools and procedures - such as optimizing the Risk and Control Assessments (R&CA) processes, highlighting KPIs in the early stage of launch, without compromising with the promise to reach people more effectively and securely through technological advancements. This paper focuses on the likely banking revolution in the country and the Operational Risks associated with establishment of these banks.*

KEYWORDS : Payment Banks, Operational Risks, BCBS, Risk and Control Assessments

Introduction:
There are more than 100+ Scheduled commercial banks, 1600+ Urban cooperative banks, 12000 NBFC and numerous payment /technology operators In India. Still, only 53% Indians have a bank account. Not to mention, 125 million of the total bank accounts were opened after the Indian government launched Pradhan Mantri Jan Dhan Yojana scheme in August 2014. In India, not only account penetration is comparatively low, but so is the use of accounts for payments — mere 15 per cent of adults reported using an account to make or receive payments. That brings India to the world's second unbanked population in the world, following China.

Realizing the immense potential of technological advancements, the Reserve Bank of India proposed niche banks to further materialize the agenda of financial inclusion called 'Payment Banks'. These banks will provide small savings accounts and payments/remittance services mainly to migrant labor workforce, low-income households, small businesses, etc. by enabling high volume-low value transactions in deposits and payments/remittance services in a secured technology-driven environment. They can accept demand deposits — current deposits and savings bank deposits — from individuals, small businesses and other entities, but there is an upper limit of Rs 1 lac per customer. Customers will earn interest on their savings account balance. The payments banks can accept and send remittances. They are also allowed to undertake utility bill payments and can distribute MF, Insurance and Pension products. However, they cannot lend to customers or issue credit cards.

This also brings the point that nearly 50% of the population don't have a debit/credit/net banking or are not financially literate enough to request for them. This is where the opportunity lies for the payment banks to 'Bank the unbanked.' However, as opportunity and risk go hand-in-hand, this would also bring a whole new paradigm of risk palette for the payment banks which never primarily troubled the fully-functional banks.

Background:
As per BCBS, "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." As the payments bank will not have loans and advances, it will not have significant credit and market risks. However, it will be exposed to Operational Risk and need to establish a robust Operational Risk Management framework. To address the same, payments banks will also be required to invest in technological infrastructure for its operations.

Current Scenario of Operational Risk in mainstream banks:
The regulators demand a greater level of insight and awareness from banks about the risks, and the effectiveness of the controls to reduce or mitigate these risks. Further, compliance regulations, like Basel II and SOX, mandate a focus on Operational Risks, forcing organizations to identify, measure, evaluate, control and manage this ubiquitous risk. The banks currently perform the Risk Analysis and Risk & Controls Self-Assessments (RCA) which forms a core part of the overall Operational Risk framework, and enables organizations to document and evaluate the residual risk - including processes, risks, events, Key Risk Indicators (KRI) and controls. Reckoning the inputs from the above metrics, reports are prepared for visibility into the risk analysis and highlighting key risk metrics for the risk managers and executive board.

Challenges of managing Operational Risk in Payment Banks:
The discipline of Operational Risk is at a crossroads. Despite the leniency of RBI to let payment banks calculate capital adequacy ratio under Basel Committee's standardized approaches, payment banks still have much work to do. Before defining the Operational Risk framework for payment banks, risk managers need to ask themselves questions like, 'How does the discipline add value to my organization?'; 'What are the Operational Risks my firm is facing?'; 'What is the strategic role of Operational Risk my firm should adopt?'

Following are some of the unique challenges that ORM brings to payment banks:

i. Cost of Compliance: The current model of payment banks doesn't allow them to make loans. This limits payment banks to generate more assets. It is also illustrious that development of an ORM model as part of a regulatory and economic capital framework is complex, takes time and resources.

ii. Access to Appropriate Information and Reporting: Effective management of Operational Risk requires diverse information from a variety of sources including - risk reports, risk and control profiles, Operational Risk incidents, key risk indicators, risk heat maps, and rules and definitions for regulatory capital and economic capital reporting. All of these are yet to be customized to the structure in which payments banks would work.

iii. Development of Loss Databases: A well-structured Operational Risk framework requires development of databases to capture loss events attributable to various categories of Operational Risk. This is yet to be built-up for payment banks framework.

iv. Lack of Systematic Measurement of Operational Risk: Many enterprises hold that their institutions are measuring Operational Risk. However, very few of them have been able to complete the Basel II quantification requirements, or yet to formalize the measurement process around the Basel II framework.

v. Implementation of ORM Systems: ORM frameworks need to demonstrate value by making use of the entire value chain of Operational Risk processes. Amidst various factors that could help corroborate this – a well-defined ORM system is essential to develop a cross-functional ORM framework as well as overall transparency across various verticals. Given the budget constraint payment banks would be working on, this would be complex and may take time. Some payment banks may either struggle with the requirements of the BIS recommendations paper, or may not yet have in place the required governance or framework. Factors like lack of understanding of upcoming technology regarding Operational Risk Management, failure to get the top management to focus on the benefits of the program and tool, improved productivity and quality, as well as on loss reduction, and lack of meaningful and timely data across business unit and product lines make the implementation of an ORM system all the more formidable.

vi. Involvement of Top Management: Effective risk management program starts with "The Tone at the Top"- driven by the top management and adhered by the bottom line. However, if leaders of payment banks perceive Operational Risk Management solely as a regulatory mandate, and not the opportunity to robust the Operational Risk framework and leverage that opportunity, they may tend to be less supportive of such efforts. Management board must understand the importance of Operational Risk, with sufficient demonstration of support for its management. They should also designate a managing entity and framework - one that is part of the bank's overall corporate governance and oversight framework.

Conclusion:

There cannot be 'one-size-fits-all' approach to Operational Risk Management. Every enterprise follows a framework that is specific to its own internal operating environment. There is no "standard" standard. The Operational Risk framework should not be just BIS compliant, done for the sake of regulatory requirements; it should also provide the payment banks with mechanisms for improving overall risk culture and behavior towards Operational Risk Management. Having said that, payment banks should come up with their own improvisations of how they would like to maintain a robust Operational Risk framework considering the challenges highlighted above. They need to come up with their own scenarios in reducing the overall processes but maintaining the same oversight, and ask questions at initial stages. For instance, before incorporating the KRIs in the process, they should ask if we need all the KRIs or could they be incorporated in the Risk and Control Assessments only? At the same time, they should also perform due diligence and should not remove mandatory processes and fall for regulators. In the background of limited resources to the formal Operational Risk system, the need to introduce newer frameworks is the way to go, and so the challenges. By approaching it in a structured and comprehensive way, payment banks can realize significant financial impact and benefit from an improved reputation with external stakeholders, including customers, investors and regulators.

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