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Risk Management in Banking and Insurance Sector

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ABSTRACT

Risk is inherent in any walk of life in general and in financial sectors in particular. Till recently, due to regulated environment, banks could not afford to take risks. But of late, banks are exposed to same competition and hence are compelled to encounter various types of financial and non-financial risks. Risks and uncertainties form an integral part of banking which by nature entails taking risks. There are three main categories of risks; Credit Risk, Market Risk & Operational Risk. Explores the concept of business risk and examines the roles and responsibilities of financial services sector enterprises engaged in its regulation, measurement and management.

Keywords : Introduction,Priorites for the banking sector, major challenges, crisis, assessment of sensitive risk.

Risk Management
The nature and magnitude of risk in business enterprises, banks and insurance companies; risk management and business regulation; risk identification, measurement, analysis, evaluation and control; principles of risk management; risk management models; risk retention and transfer; risk and capital management in business enterprises and financial institutions.

Banking
Credit, interest rate, market, liquidity, operational, foreign exchange and other major risks in banking; banking regulation; risk models; asset and liability management; internal and external credit ratings; hedging and derivatives; portfolio and capital management.

Insurance
The role and function of insurance and reinsurance enterprises; regulation of insurance companies; the underlying principles and technical processes involved in underwriting; asset and liability management; modelling and appraising the capital adequacy and performance of insurance companies

Risk Management - Priorities for the Indian Banking Sector
The new decade is predicted to be more transformational than the first decade of this millennium for the Indian economy and the Indian financial system. If the last ten years have seen transformation in terms of consistently higher growth rates, adoption of core banking solutions, transformation in the payments systems and greater integration with the global economy, the coming decade will see unprecedented volume of business for the Indian financial system as it tries to meet the challenges and requirements of rapid and inclusive growth. Information Technology (IT) has made it possible for banks to deal with large numbers and such growth in volume and value of business will obviously imply huge challenges for risk management, which in turn will have to depend on human resources and IT in dealing with the new normal- a theme so apt for this conference.

2. The major challenge is, clearly, having the human resources of the right kind and numbers and the ability to retain skilled personnel. From having personnel to deliver banking services to the poorest, to having the expertise to deliver sophisticated financial products and adopt consistent risk management practices across the organization, will be the key to managing huge organizations optimally.

3. If one of the reasons for the global financial crisis was that the financial sector grew out of sync with the real sector in the advanced economies, in India the position is different in that the financial system has to ensure that it meets the requirements of the growing real sector. Risk is inherent in banking as banks essentially trade in risk in the process of maturity transformation. Therefore, banks cannot afford to be risk avoiders. At the same time 'banker's prudence', something that is critical to safety of the depositors' funds, has to be the underlying philosophy at all times. The risk return relationship has to be optimally balanced for welfare enhancing outcomes.

4. The crisis has thrown up some critical issues relevant to risk management policies:

- The business model matters. Banks that were extremely aggressive in the trading books were clearly more affected. Those that had a fair degree of traditional banking were less affected.
- There has to be an intuitive approach to risk. Despite huge growth in leverage and huge expansion of 'on' and 'off-balance' sheet items, complex risk models threw up measures of risk that seemed to be quite capable of being absorbed. There was obviously a clear limitation to these models especially in times of stress. The inadequacies stemmed from two perspectives –

(a) Use of past data without adequately factoring in the data from acute periods of stress and
(b) The presumption that the highly sophisticated mathematical models could be as successful as they are in physical sciences.

The latter presumption is clearly wrong inasmuch as financial events are heavily influenced by largely unpredictable or irrational human behaviour which models cannot capture. Nevertheless, these are useful when considered as one of the inputs supplemented by stress/ scenario analysis and informed judgement. The other aspect which causes serious concern is that the comprehension of these models remains confined to a small group of Quants and it becomes very difficult for the top management and boards to comprehend the actual risk undertaken by the organization. These lessons will have to be kept in view now that some of the banks will move towards advanced approaches.

- Pricing of risk is important. There is a temptation to underprice risk whenever there is excess liquidity and pressure to generate profits. Pricing below cost can be risky and the risk cost is very often not captured adequately. More-

over, this gives rise to asset price bubbles with attendant implications.

- While credit, market and operational risk are captured in the capital framework under Pillar I of Basel II, liquidity risk, concentration risks, strategic risk, reputation risk and risks arising out of securitization, off balance sheet vehicles, valuation practices need to be recognized. Banks' Boards need to focus on all these risks and set firm wide limits on the principal risks relevant to the banks'

activities. Banks should focus on robust stress testing. Compensation packages should also form part of risk management policies.

- This crisis has also highlighted the importance of internal controls, good corporate governance and risk management. As shown in the Senior Supervisors Group Report on Risk Management, some banks with strong risk management systems weathered the current crisis much better than many banks that had poor or inadequate risk management systems.
- For banks that are part of financial conglomerates, the process of risk management must focus on intra group exposures and transactions as also group wide exposures to sectors and borrowers.
- The new element recognized in this crisis is that even while sound risk management policies are observed at the firm level there could be systemic risks over which individual banks have no control and this calls for risk management at the systemic level – viz. ensuring financial stability by financial regulators and policy makers

5. I will now turn to the key areas where banks need to focus while planning their businesses for higher growth, keeping in view the on-going international regulatory initiatives. The Basel Committee has brought out on December 17, 2009, two consultative documents containing key proposals that will be taken up for an impact study before adoption. These proposals cover raising quality and coverage of capital to ensure loss absorbency on a going and gone concern basis, greater stress on Tier-I and common equity component, introduction of leverage ratio, measures to deal with pro cyclicality such as capital buffers and forward looking provisioning, introduction of minimum liquidity ratios and enhanced capital for trading book securitizations and counterparty credit exposures.

6. While our assessment is that Indian banks will be generally able to meet these enhanced requirements, it is useful to see on a rough and ready basis what the present position is in this regard. Our assessment shows that:

- The common equity component as percent of total assets stood at 7 per cent in March 2009 for Indian banking sector as against a range of 3 per cent to 4 percent for large international banks. Total CRAR is 13.75 percent with Tier I at 9.4 per cent. Thus Indian banks are in a position to meet the growth requirements currently and have reasonable period to plan and raise required capital for future growth.
- The leverage ratio for Indian banks including credit equivalents of off-balance sheet) was about 17 per cent in March 2009 and can be considered reasonable.
- While the SLR has stood us in good stead, banks would do well to assess their liquidity risk against the more calibrated liquidity ratios put out in the consultative document such as the proposed short term liquidity coverage ratio and long term net stable funding ratio. This should be a regular exercise for banks that have significant share of bulk deposits and CDs.
- The Basel proposals for forward looking provisioning are based on advanced approaches using through the cycle PDs etc. In India, banks are yet to adopt advanced approaches. The gross NPAs for the banking sector have increased from 2.4 per cent as on March 31, 2008 to 2.6 per cent as on September 30, 2009. In the context of the rising NPAs and the likely slippages in the restructured accounts, we had introduced the 70 per cent provisioning coverage ratio for NPAs as a forward looking requirement. Most banks currently meet this ratio. For standard assets, in alignment with the Basel proposals for forward looking provisioning, more work needs to be done based on sectoral trends and measurements of estimated loss based on something like the Spanish dynamic provisioning model.

7. Let me next turn to the areas where banks need to be sensitive to risk:

- While overall, credit growth in the banking sector has been slower in the current year, certain sectors like real estate, infrastructure and NBFCs have seen higher rates of growth. Credit to commercial real estate (CRE) has fallen in the half year

  ended September 2009 evidencing higher risk perception. However credit to NBFCs and infrastructure continues to be high. While the country needs infrastructure financing of significant magnitude, banks that essentially mobilise short term resources do face risk on account of ALM, large size exposures and some risks beyond their control such as implementation hurdles. The emergence of long term investors such as pension and insurance funds, development of corporate bond market, and single name CDS may help in de-risking to a certain extent banks exposures to infrastructure.
- A phenomenon that RBI has brought to attention of banks recently is the large investments by banks into debt oriented mutual funds. MFs have invested large amounts in bank CDs. Banks that have a significant part of their liabilities in form of CDs have to be sensitive to the rollover risk. Equally, banks that have large investments in MFs have to be sensitive to the liquidity risk in the event of the need for sudden redemption by large investors at the same time. This distortion -whereby MFs are apparently acting as intermediaries in what should otherwise have been intermediated in the interbank market - is something that needs to be addressed. Besides there are concerns about the direction of flow of resources through MF intermediation.

Conclusion

To conclude, Indian banking system which has shown resilience in withstanding the global crisis is well placed to meet the requirements of the rapid inclusive growth. Even in the new paradigm under Basel, the system is well placed in terms of capital and liquidity. Strong HR and sound risk management practices will stand the banks in good stead while they strive to meet the challenges of the next decade.