Demystifying Risk Management – Business & Growth Implications

Bhavana Raj KONDAMUDI*, Dr. SINDHU**

ABSTRACT

There is a misplaced notion that Risk Management and Business Development are at crossroads, which is based on the premise that the Business Managers tend to compromise in certain areas of Risk Management in the interest of the business growth. But, in the larger interests of the Risk Management and the Business Growth as well, the Business Managers should be actively involved in facilitating effective Risk Management. In fact, an effective Risk Management would facilitate a healthy understanding of the exposure and its inherent Risks, leading to healthy business growth for the Banks and thus protect the stakeholder value.

1. Introduction

The etymology of the word 'Risk' can be traced to the Latin word ‘Rescum’ or French word ‘Risco’ meaning ‘That Cuts’ or ‘Causes Loss’. Risk is associated with uncertainty and reflected by way of change in the basic structure. These Risks are inter-dependent and events affecting one area of Risk can have ramifications and penetrations for a range of other categories of Risks.

Risk Management may broadly be defined as an Art or Science that facilitates identification and management of the possible deficiencies in any activity that may result in its underperformance. Risk is the possibility of the actual outcome being different from the expected outcome.

Banking has been undergoing metamorphic changes, depending upon the economic drivers, geographical requirements, social compulsions and practices etc. Banking, like any industry, is embedded with lots of Risks. The Risk Managers are constantly evolving sound banking practices that could take care of the effective Risk Management, so that both the ‘giver’ and ‘taker’ are reasonably protected from the possible adversities and thus safeguard sound economic activity.

The most effective way of doing banking business would be to take reasonable Risks and derive the benefit out of such Risks. Thus the core spirit of Risk Management would be ‘to be aware of the Risks’ and ‘find the ways and means to mitigate such Risks’, rather than develop the ‘tendency of Risk-Averse’.

2. Literature review

Risk management

Risk is all pervasive and is prevalent in every activity, be it a manufacturing or trading or service related. Human beings always attempt to manage the Risks faced by them in their day-to-day activities of life. Keeping inflammable material away from fire, saving for possible future needs, creation of a legal protection etc. are some of attempts at managing the Risks.

While there is no formal documentation of Risk Management in the primitive form of economic activity like ‘barter’ system, it would be reasonable to assume that both sides of the exchange-trade were prudently applying the basics of Risk Management viz. no loss or low loss. The extent of loss, whatever it may be, should have been the dictate of the ‘need’. Broadly, this dictate of the ‘need’ may be classified as the primitive form of Risk-Return Trade-off.

As rightly said, anyone who is not comfortable in drilling in the middle of seas is probably does not belong to the oil exploration business. Similarly, anyone who is not prepared to take Risks is not in the banking business. Managing Risk is nothing but managing the change before the Risk manages. While new avenues for the Banks have opened up, they have brought with them new Risks as well, which the Banks will have to manage and attempt to mitigate.

Every Industry strives to arrest these Risks with a view to minimize its losses and make optimum revenue. Banking Industry, primarily dealing with financial services can be no exception and thus, encounters

* ** School of Management Studies, JNTUH University Kukatpally, India. E-mail addresses: bhavana_raj_83@yahoo.com (B.R. Kondamudi), sindhu999@yahoo.com (dr. Sindhu),

© 2013 EAI. All rights reserved.
with many related Risks. It is imperative that Banks have to identify and measure various Risks faced by them and initiate suitable remedial measures to mitigate them.

Banking has been undergoing metamorphic changes, in accordance with the economic drivers, geo-physical requirements, social compulsions etc. Rapid growth of industrialization supplemented by increase in agricultural production has dramatically changed the scope of Banking and expanded its horizons.

Technological advancements in telecommunication and transportation have reduced the geo-physical barriers and the Banks have stretched themselves overseas. These expanded horizons have further increased the Risk profile of the Banks. With the advent of Computers and Information Technology, there is a paradigm shift in the banking practices giving rise to more complex banking products and services, thus exposing the Banks to various new types of Risks. Risk Management in Banks is universally the same across all the domains. The significant difference in Risks and the Risk Management practices arises mainly on account of the socio-economic fabric, the business models and the policies of the sovereign concerned. The Regulators and the Risk Managers across the Globe have been defining and re-defining the Risks associated with the banking and have been attempting to find the ways and means to address such Risks, if not mitigate them completely, so that both the ‘giver’ and ‘taker’ are reasonably protected from the possible adversities and thus, ensure a sound Banking System in particular and a stable Economic System in general.

BASEL frameworks

On 26.06.1974, number of Banks had released Deutschmarks to Bank Herstatt in Frankfurt in exchange for Dollar payments deliverable in New York. Due to time-zone difference, there was lag in the Dollar payments to the Counterparty Banks. Before the payments could be effected in New York, Bank Herstatt was liquidated by the German Regulators, resulting in huge losses to the Banks who have taken the exposures. This Cross-border Settlement Risk is a major trigger point prompting the Banks across the Globe to think of comprehensive methodologies on Risk evaluation and mitigation.

BASEL – I:

With this objective, as an initiative from G20 Countries, Basel Committee on Banking Supervision (Basel Committee) under the aegis of Bank for International Settlement, had brought out the guidelines in 1988 (Basel I) for calculation of Capital Charge on Exposures (both fund based & non-fund based) and other Assets, based on the Risk Weights applicable to the counter-party, which primarily was intended to capture the Credit Risk.

The Market Risk Amendment was introduced in 1996. Basel I envisages Risk Weights to the counter-party under the premise ‘One-Size-Fits-All’. For ex: it did not differentiate between a low Risk Residential Housing Loan and highly volatile Commercial Real Estate loan etc. In nutshell, Basel I is less Risk sensitive to the ever-growing and multi-dimensional exposures of the Banking Industry.

3. BASEL – II

Basel Committee, with a view to make computation of Capital Charge on the Assets more Risk-sensitive, had brought out revised guidelines in June, 2004 (Basel II). A Comprehensive version, inter-alia including 1996 Market Risk Amendment and 2005 paper on Trading Activities and Treatment of Double Default Effects was released in June 2006. Basel II was not mandatory either on the member Banks or otherwise.

It is quite gratifying to observe that developing Economies like India and South Africa preferred to migrate to Base II as per the given time-lines, whereas a developed Economy like USA resisted its introduction. However, over a period of time, the Banks across the Globe, in their own interest, have voluntarily preferred to adopt Basel II, albeit late to suit their local conditions.

Basel II envisions that stability of Financial Markets rests on 3 mutually reinforcing Pillars viz.:

<table>
<thead>
<tr>
<th>Pillar I</th>
<th>Minimum Capital Requirements</th>
<th>Maintenance of Risk-adequate computation of Capital requirements, which explicitly includes the Operational Risk, in addition to the Credit Risk and the Market Risk.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pillar II</td>
<td>Supervisory Review</td>
<td>Establishment of robust Risk Management practices, which includes compilation of Internal Capital Adequacy Assessment Process (ICAAP) Policy and their review by the Supervisors.</td>
</tr>
<tr>
<td>Pillar III</td>
<td>Market Discipline</td>
<td>Increased transparency through expanded disclosers in the larger interests of all the Stakeholders.</td>
</tr>
</tbody>
</table>
Pillar I

Under Pillar I, Basel II has formulated a 3-tier migration to the Risk Management under Basel II Framework, viz. i) Basic Approaches ii) Middle Approaches and iii) Advanced Approaches. Each level of these approaches contained a set of guidelines to capture Capital Charge for Credit, Market and Operational Risks.

The Risks can fundamentally be subdivided into two types, i.e. Financial and Non-Financial Risks. Financial Risks involve all those aspects which deal mainly with financial aspects of the Bank, which can be broadly stratified as Credit Risk and Market Risk. Both Credit and Market Risk may further be subdivided, as per the intensity and nuances of the Risk Management. Non-Financial Risks include all the Risks faced by the Banks in its normal functioning; like Operational Risk, Strategic Risk, Political Risk, and Legal Risk etc.

A snapshot of the possible Risks the Banking Industry may be summarized as under:

<table>
<thead>
<tr>
<th>Financial Risks</th>
<th>Market Risk</th>
<th>Non-financial Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Counter Party or Borrower Risk</td>
<td>Interest Rate Risk</td>
<td>Operational Risk</td>
</tr>
<tr>
<td>Intrinsic or Industry Risk</td>
<td>Liquidity Risk</td>
<td>Strategic Risk</td>
</tr>
<tr>
<td>Portfolio or Concentration Risk</td>
<td>Forex Currency Risk</td>
<td>Reputational Risk</td>
</tr>
<tr>
<td>Sovereign Risk</td>
<td>Sovereign Risk</td>
<td>Political Risk</td>
</tr>
<tr>
<td>Forex Currency Risk</td>
<td>Portfolio Risk</td>
<td>Legal Risk</td>
</tr>
</tbody>
</table>

The above list is only indicative, but not exhaustive. Financial Risks in the Credit and Market Risks are inter-twined and complimentary. Any adverse affect on either of them may lead to adverse effect on the other. Non-financial Risks like Operational Risk and Strategic Risk etc. are all pervasive and can fuel the ill-effects of both the Credit Risk and Market Risk.

The 333-page Magnum Opus of Basel II Framework is a magnificent effort to document various methodologies to calculate the Capital Charge on various exposures taken by the Banks. Basel II has rightly introduced Capital Charge for Operational Risk. Despite the controversies surrounding the rationale underlying the compilation of Capital Charge for Operational Risk (arguably due to the severe impact on the Capital position of the Banks), it is welcome step.

If the recent failure of US and European Banks is any indication, the introduction of Capital Charge for Operational Risk by the Basel II Framework is well justified. However, Basel Committee in its wisdom did not attempt to address certain of the non-financial Risks like Reputation Risk, Legal Risk etc. and expected the Banks concerned to evaluate the respective policies depending upon the socio-economic conditions and geo-physical barriers.

Pillar II

Under Pillar II, Banks are encouraged to formulate the Internal Capital Adequacy Assessment Process (ICAAP) Policy, inter-alia capturing a realistic Risk Profile of the exposures taken by them and assess the Capital Charge required, which will be subjected to Supervisory Review by the Regulators concerned. Developing a realistic ICAAP Policy is gigantic exercise requiring ingenuity, spirit of truthfulness and robust Risk Management skills.

The ICAAP Policy has to be realistic and robust enough to stand the scrutiny of the Regulators. The Regulators in their wisdom may prescribe additional Capital Charge for the Idiosyncratic Risk of the Bank concerned and the Systematic Risk the Banking Industry per-se. A pragmatic ICAAP Policy is intended to lead to the concept of Economic Capital and reduce the Capital Arbitrage by the Regulators. However, in view of the conflicting interests of the players in the in the system, evolution of Economic Capital appears to be a distant dream.

The Banks are also encouraged to conduct Risk Controller and Self Assessment (RCSA) exercises across the cross-section of its employees (who are one of the stakeholders). RCSA exercises are intended to equip the employees mainly to address the issues relating to its Systems and Procedures, Risk Monitoring and Corporate Governance. This proved to be non-starter and the Banks are yet to take them seriously.

Pillar III

Basel Committee observed that the information given by the Banks in the Balance Sheets is barely intelligible for the common Customers and other Stakeholders. Under Pillar III, Banks are expected to maintain transparency and make additional disclosures at a desired level of integrity, over and above that have already been made in the Balance Sheets (which are made in line with the local Accountant Standards), so as to facilitate the Stakeholders take an informed decision about the Bank concerned. In the absence of the specific guidelines by Basel III on this aspect, the Regulators concerned are expected to formulate appropriate policies, as per the dictates of the banking practices prevalent in the Country concerned. However, ‘User Test’ is indicated as one of the barometers to decide the level of these additional disclosures.
4. BASEL – III

There are many and varied reasons that led to the financial crises leading to failure or closure of many of the Banks in US and European Union. Evidently, no two Economists agree on a single analysis on such events. However, the main reasons can be traced to lack of Corporate Governance and inadequate Capital base.

To address the deficiencies revealed by the late 2000s financial crisis, Basel Committee has come out with Basel III Framework in 2010, scheduled to be introduced from 2013 until 2018. Basel III is designated to be a global regulatory standard on Banks' Capital Adequacy, Stress Testing and Liquidity Risk and is aimed at:

- Strengthening the Risk Management and Corporate Governance
- Augmenting buffer quality Capital to address the Cyclical Risks
- Improving the ability to absorb shocks arising from financial/economic stress
- Enhancing Transparency in transactions and Disclosures.

The Banks across the Globe are preparing themselves to comply with Basel III Framework and provide the required Capital. However, it is disturbing to note that many a Bank is willing to provide additional Capital (which has a Cost) to meet Basel Framework norms, rather than strengthen their Risk Management and reduce the impact of both financial and non-financial Risks and thus, save the Capital allocated for taking such exposures and the cost thereof.

5. Risk management - growth and business implications

Basel Frameworks, for the Banks, on the face of it, appears to be very difficult to digest [it seeks to introduce new concepts like Haircut, Probability of Default (PD), Loss Given Default (LGD), Exposure at Default (EAD) etc.] and seems to haunt the traditional mind-set of the Risk Managers with the 'fear of unknown'. Hence, it is imperative that the myth of Basel II needs to be demystified to understand the 'Growth & Business Implications' on Banks.

The rapid growth of industrialization supplemented by increase in agricultural production has dramatically changed the scope of Banking and expanded its horizons. Technological advancements in telecommunication and transportation have increased the scope of banking business and reduced the geo-physical barriers. As result, the Banks have stretched themselves overseas. These expanded horizons have further increased the Risk profile of the Banks.

With the advancements in computers and information technology, there has been a paradigm shift in the banking practices giving rise to more complex banking products and services, thus exposing the Banks to various new types of Risks. With banking business growing leaps and bounds, may be, it is very much essential for the Banks now to look for ways and means to protect their Business and Growth.

**From Risk Management Perspective:**

Risk is a significant aspect of a banking business activity. It is the Banks' willingness to take in business Risks as quantified by the appropriate indicators and is a basic operational prerequisite to send the relative 'Risk Limits'. For estimating the Bank's Risk-bearing capacity, it is necessary to **determine the extent to which** the Bank can afford to take certain Risks at all. It is also necessary for the Banks to analyze the opportunities arising from Risk taking (Risk-Return). Though Basel II is voluntary in nature, the Banks on their own, in their own interest may have to migrate to Basel Frameworks, so as to equip themselves to protect from unexpected losses and also to be internationally competitive.
A Thought:
With ever-growing and multi-dimensional banking business models, invariably, there appears to be an opaque area that always hides the Risk even from the sharp and trained vision of the Risk managers. Robust Risk Management practices will help Banks to identify, measure and mitigate the unexpected losses (apart from the expected losses, which the Banks in any case take care of, as a normal business practice) and eventually will lead to lesser losses and help Business and Growth prospects of the Banks.

From Capital Adequacy Perspective:
Basel Frameworks seek to ensure that the available Risk coverage Capital is sufficient at all times to cover the Risks taken. Introduction of Basel Frameworks has reduced Capital to Risk Weighted Assets Ratio (CRAR or simply known as Capital Adequacy Ratio) of the Banks by around 150 bps to 200 bps, mainly on account of the new Capital charge for Operational Risk, necessitating Banks to augment their Capital.

The Capital charge for Operational Risk (as 15% of average of previous 3-years Gross Income under Basic Indicator Approach) tends to block around 10% to 12% of Banks’ Capital Funds. However, in reality, this additional Capital charge may not be adequate to meet the losses that may arise on account of Operational Risk. In any case, the lesser Risk Weights envisaged for Basel II defined ‘Retail Loans’ is expected to offset this additional Capital charge to some extent.

A Thought:
This should encourage Banks to aim and migrate to Advanced Approaches, which would help them in improving their capacity to identify, measure and mitigate the possible Risk losses and thereby, may reduce the Capital charge. A healthy Capital to Risk Weighted Assets Ratio is one of the indicators of Banks’ soundness, which should trigger the Business and Growth prospects of the Banks.

From Capital Management Perspective:
Basel Frameworks also bring forth Bank’s Capital planning and Capital augmentation thereof, vis-à-vis the Risk bearing capacity of the Bank and business growth considerations. Banks have been traditionally used to provide Capital charge for the Assets created in its books, as per the Supervisory Prescriptions. The cost of Capital should form a part of every business decision and pricing thereof. However, the basic guiding premise should be that providing Capital is no substitute for Risk Management and mitigation thereof.

A Thought:
Realistic Internal Capital Adequacy Assessment Process (ICAAP) Policy intended to capture all the possible Risks the Banks are facing or likely to face, may help Banks in providing appropriate Capital, leading to the concept of Economic Capital. A better management of Capital helps the Banks to improve their bottom lines as well as Business and Growth prospects.

From Corporate Governance Perspective:
Basel Frameworks seek a comprehensive Corporate Governance process including the management body and senior management oversight, monitoring, reporting and internal control reviews. The Banks must have to identify and measure their Risks, allowing them to ensure that adequate provision is made for holding internal Capital in relation to their Risk profile. It is intended to guide the Banks to detect the developments that may endanger the Banks, well in advance and initiate suitable remedial countermeasures. Banks may have to put in place an Integrated Risk Governance Structure and Risk Based Internal Audit to facilitate effective control of the Risk losses.

A Thought:
Risk Assessment, ICAAP and cost of Capital should form an integral part of the Banks’ Management and Decision Making Process, across all levels of decision-making, day-in and day-out. A self-assessment of Bank’s Risk profile is desirable, to gauge their preparedness and stability in case of sudden unforeseen shocks. This would facilitate better business sense leading to Business and Growth prospects of the Banks.

From Business Development Perspective:
As Risk taking or transformation of Risks constitutes a major characteristic of the banking business, it is especially important for the Banks to address the Risk Management issues. The ever-increasing complexity of banking business calls for effective functioning systems that can reduce or control the Risk profile of the Banks. Banks have to have in place Risk Management Practices consistent with their business profile without losing focus on the vision, mission, business plans and ethics of the Bank. Banks have to view Basel Frameworks as an opportunity to improve functioning of the Banks and thereby Business and Growth prospects as well.
A Thought:
Banks have to develop appropriate Risk Management practices that can identify and measure the Risks and mitigate them as far as possible, without compromising the business objectives and growth plans. In fact, the Banks ought to put in place robust Risk Management practices, not only to insulate them from the possible losses but also to be internationally competitive, which facilitate Business and Growth prospects of the Banks.

From Technology & MIS Perspective:
Basel Frameworks envisage that Banks develop robust MIS to meet with the stringent standards of Basel and also facilitate capturing of 5 to 7 years historical data, enabling near-accurate calculation of Risk ratios like PD (Probability of Default), LGD (Loss Given Default), EAD (Exposure at Default) etc. in the Advanced Approaches. Almost all the Banks have moved to wider platform like Core Banking Solutions. As Core Banking Solutions per-se cannot support robust MIS and historical-data-perspective, the Banks will have to move towards setting up Data Warehouse etc., which may require huge investments. Building up of historical data and analysis thereof for the Business Intelligence purposes is quite essential for Banks move towards a healthy banking domain. It is needless to emphasize that Banks do require adequate Business Intelligence support to be competitive and help their Business and Growth prospects.

A Thought:
Banks may have to make these investments in Technology and Infrastructure, not as Basel driven compulsions, but as Business-driven investments. A wider platform like Core Banking Solutions supported by Data Warehouse becomes essential for the ever-growing and complex banking operations. As setting up of individual Data Warehouse by each of the Bank may become uneconomical. The Banks may have to think of sharing the Data Warehouse facilities, with suitable protection for data secrecy and integrity. In the larger interest of the Banks, a Regulatory intervention in this regard may be desirable.

From Employee Perspective:
Basel Frameworks seek to introduce fairly new concepts, which in all fairness are difficult to digest for the traditional operating personnel of the Banks. Banks may have to invest substantial time and money in updating the skill levels and motivation quotient of the operating personnel. It has been an established fact that ill-informed and ill-motivated operating personnel contribute negatively and hamper Business and Growth prospects of the Banks. Yet, this is often the most neglected area in the Banking Industry.

A Thought:
Training system being run by the Banks is often confined to improving only the knowledge levels of the operating personnel (leaving aside the controversy over its utilization in the ground level situation). It is high time; the training system migrates from ‘Training the Employees’ to ‘Educating the Employees’, meaning ‘Imparting Knowledge with Values’.

From Stakeholders Perspective:
Banking Business should not be rooted exclusively in Supervisory consideration or business consideration, rather it should be in the best interest of all Stakeholders of the Banks i.e., shareholders, customers, employees etc., who are inherently interested in the continued and sound existence of the Banks. Though the individual interests of these groups are not completely congruent, by and large, all the groups would be interested in ensuring that the Banks do not take on Risk positions that might endanger their continued and sound existence. The Stakeholders, if well informed, would fuel the Business and Growth prospects of the Banks.

A Thought:
Pillar III Disclosures of Basel II Framework appear to be the right attempt in this direction, which would need improvement over a period of time to meet the ‘User Test’ norms. To sustain the spirit behind these guidelines, the Banks have to be honest and transparent in making true and fair additional Disclosures.

From Group Perspective:
Basel Frameworks envisage that financial group entities of a Bank (except Insurance entities, which have a different Risk profile that of the financial entities and probably, are outside the scope of Basel Framework) also function on sound lines as that of the Parent Bank. Any adverse movement in the group entities would adversely affect the Parent and at times, can be fatal enough to wipe out the Parent itself. On the same analogy, many a Regulator across the Globe have mandated that Banks will have to migrate to Basel Frameworks, both at whole Bank (Solo) level and at the Consolidated (Group) level as well. This would ensure the Business and Growth prospects of the Banks and their Group entities as well.
A Thought:
The Group concept of Basel Frameworks may lead to an anomalous situation, where Group-controlled NBFCs may have to adhere to Basel Frameworks, whereas independent NBFCs need not only comply with the Framework. This is a serious issue requiring immediate remedial action by the Regulators concerned.

From Economic Perspective:
The Banking System is one of the important barometers of the Economic stability of the System. Hence, any Economic System to achieve a robust growth and sustain the same needs to encourage and ensure a sound Banking System, the Regulators across the Globe have been defining and re-defining the regulatory interventions, so as to ensure a sound Banking System in particular and a stable Economic System in general.

A Thought:
Bankers, Economists, Regulators and Sovereigns all over the world have been continuously striving to achieve a right balance between Banking Business Growth and Risk-Return Trade Off. It is easier said than done.

From Regulatory Perspective:
Mere designing of Risk Assessment and Control Methods is not sufficient to secure the Banks’ Risk-bearing capacity. Implementation of appropriate processes and reviews is essential. For improving Risk Management on an ongoing basis, development of relevant process should not be regarded as a one-time project, but a continuous development process. Hence, proper documentation of its Risk Governance Mechanisms, Systems & Procedures, their periodical updation and implementation of the same becomes the key. The Regulators would be too eager to study these aspects and assess the Risk profile of the Banks, as these would serve as Regulatory Tools. Regulators would be interested in the sound Business and Growth prospects of the Banks and hence would be monitoring the movements of the Banking industry and give the necessary impetus and guidance and initiate course correction, of considered necessary.

A Thought:
Banking Industry is moderately regulated with the interventions of the Regulators and appears to be stable. Yet, the Risk Management practices of the Banks are not considered robust enough and hence, reengineering of the same may be required.

5. Conclusions
The Banks, on their own, in their interest, have to migrate to Basel Frameworks. The Banks have to put in place robust Risk Management practices that can help improve the areas like i) Risk Conceptualization ii) Risk Identification iii) Risk Measurement iv) Risk Monitoring v) Risk Mitigation and vi) Risk-Return Trade-off etc.

To facilitate robust Risk Management, the Banks may have to...

- Update the Skill Levels of the Employees
- Reengineer the Systems & Procedures
- Strengthen the MIS and Data capturing capabilities
- Augment adequate good quality Capital
- Improve Corporate Governance, Monitoring and Oversight
- Map a realistic Internal Capital Adequacy Assessment Process Policy
- Increase integrity in mapping the Risks
- Develop mechanisms to quantify the impact of the Risks and
- Initiate suitable remedial measures to mitigate the Risks

…and, these would evidently go a long way in developing the Business and Growth prospects of the Banks and also make them globally competitive.

Acknowledgements
Work on this research paper was possible only with the encouragement and support from many people. I am extremely indebted to my guide Dr. Sindhu, Associate Professor, Ph.D., School of Management Studies (SMS) & Research Coordinator R & D (Research and Development), JNTUH University(Jawaharal Nehru Technological University Hyderabad), Kukatpally, Hyderabad-500085, Andhra Pradesh, India., for providing necessary guidance to accomplish my research work. I am very much thankful to her for her valuable advice, constructive criticism and her extensive discussions around my research work.
References