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# Risks in banking sector

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**Abstract**
Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and impact of unfortunate events or to maximize the realization of opportunities. Risk management's objective is to assure uncertainty does not deflect the endeavor from the business goals. Risk Management is the application of proactive strategy to plan, lead, organize, and control the wide variety of risks that are rushed into the fabric of an organization's daily and long-term functioning. Risk is an exposure to a transaction with loss, which occurs with some probability and which can be expected, measured and minimized. In financial institutions risk result from variations and fluctuations in assets or liability or both in incomes from assets or payments and on liabilities or in outflows and inflows of cash. Today, banks are facing various types of risks like Credit risk, Market risk, Operating risk. For any financial institutions like banks, risk management is essential for success and survival in this competitive world. This paper also examined the different techniques adopted by banking industry for risk management. For this study data collected from secondary sources.

**Keywords:** Risk management, banking sector, credit risk, market risk, operating risk

## Introduction
A risk can be defined as an unplanned event with financial consequences resulting in loss or reduced earnings. Therefore, a risky proposition is one with potential profit or a looming loss. Risk stems from uncertainty or unpredictability of the future. In commercial and business risk generates profit or loss depending upon the way in which it is managed. Risk can be defined as the volatility of the potential outcome. Risk is the possibility of something adverse happening. Risk management is the process of assessing risk, taking steps to reduce risk to an acceptable level and maintaining that level of risk. Risk is defined as anything that can create hindrances in the way of achievement of certain objectives. It can be because of either internal factors or external factors, depending upon the type of risk that exists within a particular situation. Exposure to that risk can make a situation more critical.

## Objectives the Study
The following are the objectives of the study.
i. To identify the risks faced by the banking industry.
ii. To trace out the process and system of risk management.
iii. To examine the techniques adopted by banking industry for risk management

## Research Methodology
This paper is theoretical modal based on the secondary source of information has gathered. The sources include online publications, Books and journals

## Types of Risks in Banking Sector
**1. Credit Risk:** This is the risk of non recovery of loan or the risk of reduction in the value of asset. The credit risk also includes the pre-payment risk resulting in loss of opportunity to the bank to earn higher interest income. Credit Risk also arises due excess exposure to a single borrower, industry or a geographical area. The element of country risk is also present which is the risk of losses being incurred due to adverse foreign exchange reserve situation or adverse political or economic situations in another country

**2. Interest Rate Risk:** This risk arises due to fluctuations in the interest rates. It can result in reduction in the revenues of the bank due to fluctuations in the interest rates which are dynamic and which change differently for assets and liabilities. With the deregulated era interest rates are market determined and banks have to fall in line with the market trends even though it may stifle their Net Interest margins

**3. Liquidity Risk:** Liquidity is the ability to meet commitments as and when they are due and ability to undertake new transactions when they are profitable. Liquidity risk may emanate in any of the following situation

(a) net outflow of funds arising out of withdrawals/non renewal of deposits
(b) non recovery of cash receipts from recovery of loans
(c) conversion of contingent liabilities into fund based commitment

**4. Foreign Exchange Risk:** Risk may arise on account of maintenance of positions in forex operations and it involves currency rate risk, transaction risks (profits/loss on transfer of earned profits due to time lag) and transportation risk (risks arising out of exchange restrictions)

**5. Regulatory Risks:** It is defined as the risk associated with the impact on profitability and financial position of a bank due to changes in the regulatory conditions, for example the introduction of asset classification norms have adversely affected the banks of NPAs and balance sheet bottom lines.

**6. Technology Risk:** This risk is associated with computers and the communication technology which is being increasingly introduced in the banks. This entails the risk of obsolescence and the risk of losing business to better technologically.

**7. Market Risk:** This is the risk of losses in off and on balance sheet positions arising from movements in market prices. Market risk is the risk to the bank‟s earnings and capital due to changes in the market level of interest rates or prices of securities, foreign exchange and equities, as well as the volatilities, of those prices.

**8. Strategic Risk:** This is the risk arising out of certain strategic decisions taken by the banks for sustaining themselves in the present day scenario for example decision to open a subsidiary may run the risk of losses if the subsidiary does not do good business.

**Process of Risk Management**

To overcome the risk and to make banking function well, there is a need to manage all kinds of risks associated with the banking. Risk management becomes one of the main functions of any banking services risk management consists of identifying the risk and controlling them, means keeping the risk at acceptable level In risk management exercise the top management has to lay down clear cut policy guidelines in quantifiable and precise terms - for different layers line personnel business parameters, limits etc. It is very important for the management to plant at the macro level what the organizations is looking in for in any business proposition or venture and convert these expectations into micro level factors and requirements for field level functionaries only then they will be able to convert these expectations into reality. A very important assumption is made but normally omitted or over looked is provision of infra-structural support and conductive climate. Ultimately top management has a greater role to play in any risk management process

In the process of risk management following functions comprises:

- Risk identification
- Risk measurement or quantification
- Risk control
- Monitoring and reviewing

**1. Risk identification:** involves the naming and defining of each type of risk associated with a transaction or type of product or service. It includes the understanding the nature of various kinds of risks. The circumstances which lead a situation to become a risk situation and causes due to which the risk can arise.

**2. Risk Quantification:** Risk quantification is an assessment of the degree of the risk which a particular transaction or an activity is exposed to. the estimation of the size, probability and timing of potential loss under various scenarios Though the exact measurement of risk is not possible but the level of risk can be determined with the help of risk rating models.

**3. Risk Control:** Risk control is the stage where the bank or institutions take steps to control the risk with the help of various tools.

**4. Risk Monitoring:** In risk monitoring the bankers have to fix up the parameters on which the transaction is to be tested to be sure that there is no risk to viable existence of the financial unit or investment of the bank

**Techniques of Risk Management**

**a. GAP Analysis**

It is an interest rate risk management tool based on the balance sheet which focuses on the potential variability of net-interest income over specific time intervals. In this method a maturity/ re-pricing schedule that distributes interest-sensitive assets, liabilities, and off-balance sheet positions into time bands according to their maturity (if fixed rate) or time remaining to their next re-pricing (if floating rate), is prepared. These schedules are then used to generate indicators of interest-rate sensitivity of both earnings and economic value to changing interest rates. After choosing the time intervals, assets and liabilities are grouped into these time buckets according to maturity (for fixed rates) or first possible re-pricing time (for flexible rate s). The assets and liabilities that can be re-priced are called rate sensitive assets (RSAs) and rate sensitive liabilities (RSLs) respectively. Interest sensitive gap (DGAP) reflects the differences between the volume of rate sensitive asset and the volume of rate sensitive liability and given by, GAP = RSAs – RSLs The information on GAP gives the management an idea about the effects on net-income due to changes in the interest rate. Positive GAP indicates that an increase in future interest rate would increase the net interest income as the change in interest income is greater than the change in interest expenses and vice versa.

**b. Value at Risk (VaR)**
The Value at Risk (VaR) indicates how much a firm can lose or make with a certain probability in a given time horizon. VaR summarizes financial risk inherent in portfolios into a simple number. Though VaR is used to measure market risk in general, it incorporates many other risks like foreign currency, commodities, and equities

**c. Risk Adjusted Rate of Return on Capital (RAROC)**
It gives an economic basis to measure all the relevant risks consistently and gives managers tools to make the efficient decisions regarding risk/return tradeoff in different assets. As economic capital protects financial institutions against unexpected losses, it is vital to allocate capital for various risks that these institutions face. Risk Adjusted Rate of Return on Capital (RAROC) analysis shows how much economic capital different products and businesses need and determines the total return on capital of a firm. Though Risk Adjusted Rate of Return can be used to estimate the capital requirements for market, credit and operational risks, it is used as an integrated risk management tool

**d. Securitization**
It is a procedure studied under the systems of structured finance or credit linked notes. Securitization of a bank‟s assets and loans is a device for raising new funds and reducing bank‟s risk exposures. The bank pools a group of income-earning assets (like mortgages) and sells securities against these in the open market, thereby transforming illiquid assets into tradable asset backed securities. As the returns from these securities depend on the cash flows of the underlying assets, the burden of repayment is transferred from the originator to these pooled assets.

**e. Sensitivity Analysis**
It is very useful when attempting to determine the impact, the actual outcome of a particular variable will have if it differs from what was previously assumed. By creating a given set of scenarios, the analyst can determine how changes in one variable (s) will impact the target variable.

**f. Internal Rating System**
An internal rating system helps financial institutions manage and control credit risks they face through lending and other operations by grouping and managing the credit-worthiness of borrowers and the quality of credit transactions.

## Conclusion
Risk management is essential for the survival of an organization. The objective of risk management is not to prohibit or prevent risk taking activity, but to ensure that the risks are consciously taken with full knowledge, clear purpose and understanding so that it can be measured and mitigated. It also prevents an institution from suffering unacceptable loss. The banking industry is exposed to different risks such as forex volatility, risk, variable interest rate risk, market play risk, operational risks, credit risk etc. which can adversely affect its profitability and financial health. Risk management has thus emerged as a new and challenging area in banking. Basel II intended to improve safety and soundness of the financial system by placing increased emphasis on bank's own internal control and risk management process and models the effectiveness of risk measurement in banks depends on efficient Management Information System, computerization and net working of the branch activities.

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