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RISK MANAGEMENT AND ITS TYPES

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Introduction

Risk is defined as anything that can create hindrances in the way of achievement of certain objectives. It can be because of internal or external factors, depending upon the type of risk that is within a particular situation. Exposure of can make a situation critical. A better way to deal with such a situation; is to take certain measures to identify any kind of risk that can result in undesirable outcomes. In simple terms, it can be said that managing a risk in advance is far better than waiting for its occurrence.Risk Management is a measure that is used for identifying, analysing and then responding to a particular risk.

Risk Management- Definitions

Risks may be defined as uncertainties resulting in adverse outcome, adverse in relation to planned objective or expectations ***(Kumar, Chatterjee, Chandrasekhar & Patwardhan 2005).***
Investopedia - Risk management is the process of identification, analysis and either acceptance or mitigation of uncertainty in investment decision-making. Essentially, risk management occurs anytime an investor or fund manager analyzes and attempts to quantify the potential for losses in an investment and then takes the appropriate action (or inaction) given their investment objectives and risk tolerance. Inadequate risk management can result in severe consequences for companies as well as individuals. For example, the recession that began in 2008 was largely caused by the loose credit risk management of financial firms.

Risk refers to 'a condition where there is a possibility of undesirable occurrence of a particular result which is known or best quantifiable and therefore insurable' **(Periasamy, 2008).** Risk may mean that there is a possibility of loss or damage which, may or may not happen.

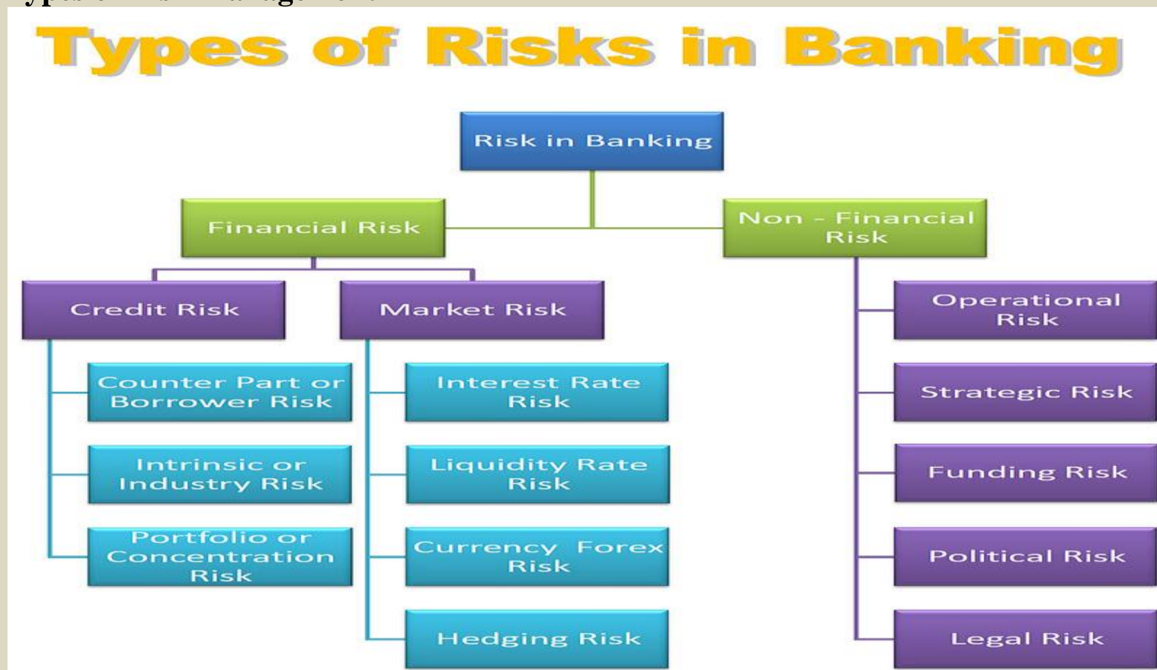
***Economic Times* -**In the world of finance, risk management refers to the practice of identifying potential risks in advance, analyzing them and taking precautionary steps to reduce/curb the risk.
In the simplest words, risk may be defined as possibility of loss. It may be financial loss or loss to the reputation/ image ***(Sharma, 2003).***

Gallati (2003) defines risk as a condition in which there exists an exposure to adversity, or a condition in which there exists a possibility of deviation from a desired outcome that is expected or hoped for.

Risk Management

Risk Analysis & Management has much importance in the any Countries Economy during its liberalization period. The challenges faced by the banking sector today is understanding and managing risk.
For management of risk at various level, risks like credit, market or operational have to be converted into one composite measure. Therefore, it is necessary that measurement of operational risk should be in behind other measurements of credit and market risk

Types of Risk Management



Types of Risk in Banks

There are mainly two types of Risks in banks.

1. Financial Risk: Financial risk arises from any business transaction undertaken by a bank, which is exposed to potential loss. This risk can be further classified into Credit risk and Market risk

2. Nonfinancial Risk: Non- financial risk refers to those risks that may affect a bank's business growth, marketability of its product and services, likely failure of its strategies aimed at business growth etc. These risks may arise on account of management failures, competition, non-availability of suitable products/services, external factors etc. In these risk operational and strategic risk have a great need of consideration.

Credit Risk – credit risk is the risk that a borrower may default on his obligation, or unable to perform under the terms of the contract.

Market Risk – The part of overall risk of an asset, organization, position or portfolio, which is due to potential changes in the market prices of assets.

Operational Risk- Operational risk is the risk of direct or indirect loss from inadequate or failed internal processes, people, and system from external events.

Financial Risk

Financial risk arises from any business transaction undertaken by a bank, which is exposed to potential loss. This risk can be further classified into Credit risk and Market risk.

1. **Credit Risk**

Credit Risk is the potential that a bank borrower/counter party fails to meet the obligations on agreed terms. There is always scope for the borrower to default from his commitments for one or the other reason resulting in crystalisation of credit risk to the bank. These losses could take the form outright default or alternatively, losses from changes in portfolio value arising from actual or perceived deterioration in credit quality that is short of default. Credit risk is inherent to the business of lending funds to the operations linked closely to market risk variables. The objective

of credit risk management is to minimize the risk and maximize bank's risk adjusted rate of return by assuming and maintaining credit exposure within the acceptable parameters.
The management of credit risk includes:
a) Measurement through credit rating/ scoring,
b) Quantification through estimate of expected loan losses,
c) Pricing on a scientific basis and
d) Controlling through effective Loan Review Mechanism and Portfolio Management.

Tools of Credit Risk Management

The instruments and tools, through which credit risk management is carried out, are detailed below:
a) **Exposure Ceilings:** Prudential Limit is linked to Capital Funds - say 15% for individual borrower entity, 40% for a group with additional 10% for infrastructure projects undertaken by the group, Threshold limit is fixed at a level lower than Prudential Exposure; Substantial Exposure, which is the sum total of the exposures beyond threshold limit should not exceed 600% to 800% of the Capital Funds of the bank (i.e. six to eight times).

b) **Review/Renewal:** Multi-tier Credit Approving Authority, constitution wise delegation of powers, Higher delegated powers for better-rated customers; discriminatory time schedule for review/renewal, Hurdle rates and Bench marks for fresh exposures and periodicity for renewal based on risk rating, etc are formulated.

c) **Risk Rating Model:** Set up comprehensive risk scoring system on a six to nine point scale. Clearly define rating thresholds and review the ratings periodically preferably at half yearly intervals. Rating migration is to be mapped to estimate the expected loss.
d) **Risk based scientific pricing:** Link loan pricing to expected loss. High-risk category borrowers are to be priced high. Build historical data on default losses. Allocate capital to absorb the unexpected loss. Adopt the RAROC framework.

e) **Portfolio Management** The need for credit portfolio management emanates from the necessity to optimize the benefits associated with diversification and to reduce the potential adverse impact of concentration of exposures to a particular borrower, sector or industry. Stipulate quantitative ceiling on aggregate exposure on specific rating categories, distribution of borrowers in various industry, business group and conduct rapid portfolio reviews.

f) **Loan Review Mechanism** This should be done independent of credit operations. It is also referred as Credit Audit covering review of sanction process, compliance status, review of risk rating, pickup of warning signals and recommendation of corrective action with the objective of improving credit quality. It should target all loans above certain cut-off limit ensuring that at least 30% to 40% of the portfolio is subjected to LRM in a year so as to ensure that all major credit risks embedded in the balance sheet have been tracked.

2. Market Risk

Market Risk may be defined as the possibility of loss to bank caused by the changes in the market variables. It is the risk that the value of on-/off-balance sheet positions will be adversely affected by movements in equity and interest rate markets, currency exchange rates and commodity 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. The following are types of market risks;

a) Liquidity Risk:

Bank Deposits generally have a much shorter contractual maturity than loans and liquidity management needs to provide a cushion to cover anticipated deposit withdrawals. Liquidity is the ability to efficiently accommodate deposit as also reduction in liabilities and to fund the loan growth and possible funding of the off-balance sheet claims. The cash flows are placed in different time buckets based on future likely behavior of assets, liabilities and off-balance sheet items. Liquidity risk consists of Funding Risk, Time Risk & Call Risk.

b) Interest Rate Risk

Interest Rate Risk is the potential negative impact on the Net Interest Income and it refers to the vulnerability of an institution's financial condition to the movement in interest rates. Changes in interest rate affect earnings, value of assets, liability off-balance sheet items and cash flow. Earnings perspective involves analyzing the impact of changes in interest rates on accrual or reported earnings in the near term. This is measured by measuring the changes in the Net Interest Income (NII) equivalent to the difference between total interest income and total interest expense.

c) Forex Risk

Foreign exchange risk is the risk that a bank may suffer loss as a result of adverse exchange rate movement during a period in which it has an open position, either spot or forward or both in same foreign currency. Even in case where spot or forward positions in individual currencies are balanced the maturity pattern of forward transactions may produce mismatches. There is also a settlement risk arising out of default of the counter party and out of time lag in settlement of one currency in one center and the settlement of another currency in another time zone. Banks are also exposed to interest rate risk, which arises from the maturity mismatch of foreign currency position.

d) Country Risk

This is the risk that arises due to cross border transactions that are growing dramatically in the recent years owing to economic liberalization and globalization. It is the possibility that a country will be unable to service or repay debts to foreign lenders in time. It comprises of Transfer Risk arising on account of possibility of losses due to restrictions on external remittances; Sovereign Risk associated with lending to government of a sovereign nation or taking government guarantees; Political Risk when political environment or legislative process of country leads to government taking over the assets of the financial entity (like nationalization, etc) and preventing discharge of liabilities in a manner that had been agreed to earlier; Cross border risk arising on account of the borrower being a resident of a country other than the country where the cross border asset is booked; Currency Risk, a possibility that exchange rate change, will alter the expected amount of principal and return on the lending or investment.

Non - Financial Risk:

Non- financial risk refers to those risks that may affect a bank's business growth, marketability of its product and services, likely failure of its strategies aimed at business growth etc. These risks may arise on account of management failures, competition, non- availability of suitable

products/services, external factors etc. In these risk operational and strategic risk have a great need of consideration.

Operational Risk

Always banks live with the risks arising out of human error, financial fraud and natural disasters. The recent happenings such as WTC tragedy, Barings debacle etc. has highlighted the potential losses on account of operational risk. Exponential growth in the use of technology and increase in global financial inter-linkages are the two primary changes that contributed to such risks. Operational risk, though defined as any risk that is not categorized as market or credit risk, is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events. In order to mitigate this, internal control and internal audit systems are used as the primary means.
Risk education for familiarizing the complex operations at all levels of staff can also reduce operational risk. Insurance cover is one of the important mitigators of operational risk. Operational risk events are associated with weak links in internal control procedures. The key to management of operational risk lies in the bank's ability to assess its process for vulnerability and establish controls as well as safeguards while providing for unanticipated worst-case scenarios.

Operational risk involves breakdown in internal controls and corporate governance leading to error, fraud, performance failure, compromise on the interest of the bank resulting in financial loss. Putting in place proper corporate governance practices by itself would serve as an effective risk management tool. Bank should strive to promote a shared understanding of operational risk within the organization, especially since operational risk is often intertwined with market or credit risk and it is difficult to isolate.
Parameters of Risk Management
Include the following:

- Risk likelihood (i.e., probability of risk occurrence)
- Risk consequence (i.e., impact and severity of risk occurrence)
- Thresholds to trigger management activities

Risk parameters are used to provide common and consistent criteria for comparing risks to be managed. Without these parameters, it is difficult to gauge the severity of an unwanted change caused by a risk and to prioritize the actions required for risk mitigation planning.
Acquirers should document the parameters used to analyze and categorize risks so they are available for reference throughout the life of the project since circumstances change over time. Using these parameters, risks can easily be re-categorized and analyzed when changes occur.
The acquirer may use tools such as failure mode and effects analysis to examine risks such as potential failures in products or processes. A tool may also be used to evaluate risk management priorities for mitigating known threat vulnerabilities.

Conclusion

Risk management underscores the fact that the survival of an organization depends heavily on its capabilities to anticipate and prepare for the change rather than just waiting for the change and react to it.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. Risk Management Committee, Credit Policy Committee, Asset Liability Committee, etc are such committees that handle the risk management aspects.The banks can take risk more consciously, anticipates adverse changes and

hedges accordingly; it becomes a source of competitive advantage, as it can offer its products at a better price than its competitors.

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