BANKS SHOULD BUILD AN INTERNAL RISK MANAGEMENT ORGANIZATION TO COUNTER VOLATILITY OF THE FINANCIAL MARKET

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ABSTRACT

It is rather unfortunate that financial institutions like banks who are enjoying highest leveraging capacity generally lack inernal risk managent culture and specific sub-groups to manage their risk. In fact there is widespread belief that they take enough collaterals to withstand their risks in lending money to their customers- both institutions and individuals. However time and again they have been facing wide range of risks and as a consequence sometime they have to ask for moratorium from the regulatory authorities and at time even have to shut their doors forever. Of late some changes could be seen due to government regulation and or regulators direction. These changes are: insistence for adequacy of capital, and also setting up an Asset Liability Management Committee. These are however inadequate as has been highlighted in the paper particularly when the banks are required to fund for inclusive growth.

Banks generally enjoy higher leveraging capability as their total assets are usually about 15 to 20 times higher than their equity capital. It would be therefore necessary for banks to have well conceived risk management plan internally also beside the oversight and control usually exercised by the regulatory authorities global as well as national Integral part of operation.

In fact risk is an integral part of operation of banks as banks operate largely as intermediary as they collect deposits of people who have surplus funds and lend the same to people who need such funds for business or even for investments in products and premises. It is obvious therefore that when banks lend money they undertake the risk of default by borrowers for one reason or the other and thereby they also undertake the risk of default to pay their depositors. This two-pronged risk need to be taken care of by banks by framing such business strategy where risk

management should be an integral part.

Core Function- Liquidity management

Banks basic function is liquidity management as they collect savings and lend the same to those who need the same for business and or for investments and thereby takes a risk of loss of those funds.

Complex Task

However risk management is a complex task and need specially trained personnel to undertake such task. It is true of late banks have instituted asset liability management committee in all banks in India to undertake this task but in reality much improvement yet to be seen in performance of these internal committees in risk management as these are yet to be manned by specially trained personnel and top management are in general not very comfortable to comprehend their findings and recommendations.

Global Impact

It is therefore increasingly gaining importance worldwide as in today's world economic events and financial systems are so closely linked that any fall out even in far flung areas would generally have an impact globally as could be seen in the sudden collapse of Meryl Lynch. It has been rightly emphasized by financial institutions and regulators both global and national that risk management is no longer in a position to confine their attention to current and or historical financial operations but to focus on its ability to identify and be well equipped to manage future risks as the best predictor of long term success. In fact instituting an effective risk management would automatically accrue several benefits that could make banks more healthy and wealthy.

Reasons to have Internal Framework

These could be enumerated as follows:

- It would provide early warning for potential risk;
- It would help measuring risk before it becomes too big to counter it;
- It would evolve a systematic process to evaluate impending risk;
- It helps management to take timely action to resolve the issue;

- It takes less time in fixing the issue and thus helps management to devote more time to develop business;
- It helps management to make more efficient resource allocation(both capital and cash);
- It allows management to quantitatively measure risk and fine tune capital allocation and liquidity needs to match the on and off balance sheet risks faced by the bank and
- It also helps evaluating the potential shocks.

Risk Management—internal framework imperative

In fact effective risk management is sine-qua-non for banks as these institutions are required to maximize their earnings with minimum risks. An efficient framework of risk management allows banks to quantitatively measure impending risks and thus empowers them to fine-tune capital allocation and liquidity requirement to match the on and off-balance sheet risks undertaken and also help evaluating the potential shocks if immediate remedial actions are not in place. In fact it helps them to remain better informed of potency of risk taken both positive and negative. In fact it helps developing pro-active and forward looking management culture and that way it virtually helps management of banks to assess new market opportunities boldly and foster continuous improvement of present operating models to effectively align performance with the strategized goals set for the institution.

Getting Embedded to Management

It is noteworthy that such increased emphasis on risk management is gradually getting embedded in bank management as such a shift is now considered as fundamental need both by banks and their regulatory agencies for obvious reasons- to better anticipate risks, rather than just react when it happens. This approach also emphasizes the imperative need of 'self supervision' and initiates pro-active measures to stall the happening of the same. It is obvious therefore that to institutionalize risk management internally would help identifying positive opportunities while becoming aware of negative threats and initiating pro-active measures to avoid any evil effects.

External oversight

Historically banks have waited for external reviews by regulators to point out internal and

external risks that they are either facing or likely to face in near future and their recommendations and ordinances to take safeguard measures to counter such events. However in today's fast changing financial environment it has been observed that regulators are often left analyzing the wreckage only after a bank or a set of banking institutions had already facing financial crisis.

CAMELS- REGULATORY TOOLS

It has therefore become imperative to foster financial health of banks to relook and revamp the CAMELS strategy as has been presently emphasized by the U.S. regulators. In these regulators have emphasized the imperative need to introduce quality internal systems to identify and address all such potential risks and problems immediately as soon as these are seen appearing and hovering around either internally or externally or both in the financial world.

FRB Guidance

As per the Federal Reserve Bank comprehensive risk management consists of adoption of such practices that are designed to limit risks associated with individual products by adopting quantitative methods to identify, monitor and control aggregate risks arising from financial products and services introduced and operated by banks.

Need to develop internal framework growing

As Banks continue to grow and expand rapidly by serving more customers and attracting more investment capital and funds from public, they need to strengthen their internal capacity to identify and anticipate potential risks to unexpected losses and shocks. It is therefore highly desirable that banks should create an internal framework to identify and anticipate potential risks to avoid unexpected losses and market shocks.

It is therefore obvious that banks should develop a risk management framework and culture to help identifying and or anticipating potential risks to avoid unexpected losses. These could be done after mastering the fundamentals of individual risks like credit risks, treasury risks and liquidity risks. In fact major categories of risks could be summed up as follows:

- Credit risks that arises from transactions and portfolio operations;
- Liquidity risks that arises from asset liability mismatch;
- Market risks that emanates from upsurge and or downturn of rate of interest and foreign exchange rates due to volatility of internal and external financial markets;

Human resource risks that may arise due to inadequate supply and or antagonistic management style including empowerment without adequate briefing, training and supervision. It would obviously include fraud, false legal compliance and also inadequate application of information technology to provide

- , alarm calls. These could be categorized as governance risks also.

It is therefore clear that risk management which is the process of managing the probability or the severity of the adverse event beyond the normal and acceptable range set by banks as set out by US Federal Reserve called CAMELS which means capital adequacy, asset quality, management quality, earnings quality, liquidity and sensitivity to interest rates. Adherence to the above would provide comprehensive risk management to banks. In fact a comprehensive approach to risk management would enable banks to reduce the risk of loss, to build credibility in the market place and create new opportunities for growth.

The strategy therefore could be enumerated as follows:

- To design policies and procedures to mitigate risks by assigning responsibilities, periodically testing effectiveness and also evaluating the results, and accordingly revising policies and procedures as found necessary;
- To comprehend that risk management is a process and need to be appraised periodically on regular as well as suddenly;
- To spread the message that each operators from the top to the bottom could play an effective role to design proactive action to prevent occurrence of such events that could harm the interest of all by hitting the profit earning capability of the bank.

It is imperative for banks and financial institutions to build appropriate tools and systems to preempts risk both inherent and emergent and train management to handle such tools and

systems with due alertness so that remedial measures could be ready at hand to overcome those risks. It would be wrong to assume that financial institutions could ever be free from risk as beside market volatility these institutions have to encounter natural and manmade hazards at all times. In fact it would not be wrong to state financial instruments are conceived to take variable risks and also priced accordingly.