Shodh Sagar Annual Student Research Journal 2020-21 ***https://www.kdpublications.in***

ISBN: 978-93-90847-43-3

5. A Study on Risk Management in Indian Banking Sectors

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5.1 Abstract:

The era of Covid 19 has highlighted the importance of Risk management in any organizations for successful running and continuous profitability of organizations. Risk is a probability of losing something and risk management is a defensive tool for any organizations who wants to increase its profitability. Bank is a financial institution which constitute an important factor in any Economy because it is a medium that transfer surplus money to the deficit where it is needed and create value for economy. It helps many businesses to grow by investing and providing finance to that business unit. So, risk management in such financial institution is crucial for economy because it operates on large scale and provide helps in optimum allocation of resources in any economy and large number of populations have depend upon it. Day by day its importance is increases and it widen its services and functions. Banks have to faces various types of risk in normal banking operations. By seeing its importance in economy RBI also have to take care of risk management in banks. It becomes an important function of RBI as RBI is banker to the banks.

Keywords:

Basel Accord, risk pricing, risk rating, Prudential limit, NPA

5.1.1 Introduction:

Banks in the process of financial intermediation are confronted with various kinds of Financial and non-financial risks viz., credit, interest rate, foreign exchange rate, liquidity, Equity price, commodity price, legal, regulatory, reputational, operational, etc. These Risks are highly interdependent and events that affect one area of risk can have Ramifications for a range of other risk categories. Thus, top management of banks should attach considerable importance to improve the ability to identify, measure, monitor and Control the overall level of risks undertaken. To deal with such financial and non-financial risk RBI also frame a rules and guidelines and work on it.

CAMEL Model:

Earlier RBI used to follow the CAMEL model for supervising the banks. According to this approach, emphasis was provided to the few parameters such as

- Capital,
- Asset Quality of the Bank,
- Management Quality,
- Earning Quality or Net Interest Margin of the Bank,
- Liquidity position of the bank as well as sensitivity of the banks toward the market risk.

ALM model:

ALM stands for Asset and Liabilities management. The objective of ALM is to maximize returns through efficient fund allocation given an acceptable risk Structure.

BESAL Accords:

First Basel Accord of 1988, „Basel I". The objective was to create uniform risk management policy across the globe. According to Basel I, it was decided that banks have to maintain at least 8% capital adequacy ratio to hedge against the credit risk. Basel I was focusing only on credit risk where Basel II emphasized on market risk and operations risk apart from the credit risk. Basel II norms came afterwards and in Basel II, there were three main pillars. The three pillars include

- Minimum capital requirement,
- Mandatory disclosure and
- Close supervision.

After a 2008 great recession it was felt that there is need of new BASEL regulations according to that Basel III is a recent development in the area of banking sector where major impetus has been provided towards the liquidity risk. The Macro Economic Assessment Group was established in February, 2010 by the chairs of the financial stability board and Basel Committee on Banking Supervision to coordinate an assessment of macro-Economic implications. According to the BASEL III norms, Banks are required to hold a capital conversion buffer comprising 2.5% of common Equity. The countercyclical buffer would be as large as 0-2.5% position of risk Weighted assets. Reserve and surplus should not be less than 2%. Therefore for 18 Successful implementations of the BASEL III, banks have to maintain at least 11.5% capital adequacy ratio.

5.2 Literature Review:

Suresh N, Anil Kumar S, and Gowda D.M (2009) conducted a study to establish a framework for measuring and managing credit risk for fifteen private banks in India. The main aim of the research was to evaluate the Non-Performing Assets (NPAs) as a percentage of total assets of private banks. It was concluded that the NPAs level of private banks had a decreasing trend and by comparing the critical values, it was found that homogeneity does not exists among banks with their credit exposures.

Credit Risk Management in Indian Commercial Banks was undertaken by Ms. Asha Singh explains the credit risk management which includes identification, measurement, monitoring and control of the credit risk exposures.

Credit risk management in Indian banks was conducted by Patil Jaykar Bhaskar (2014) discussed about various tools and techniques to manage credit risk. He has observed that levels of authority for credit approval help to guarantee that decisions are prudent and are made within defined parameters.

5.2.1 Research Methodology:

We use secondary data such as various previous research done and Papers publish by various authors. Various guidelines publish by RBI as well as Research and data publish by the RBI based on this subject. RBI Notification release By RBI from time to time.

5.2.2 Objective of the Study:

- To study how banks manages this risk & try looks at NPA’s impact on banks
- To study role of RBI in the risk management of banking

5.3 Risk Management System in Indian Banking System:

The broad parameters of risk management function should encompass:

a. Organizational structure;
b. Comprehensive risk measurement approach;
c. Risk management policies approved by the Board which should be consistent with the broader business strategies, capital strength, management expertise and Overall willingness to assume risk;
d. Guidelines and other parameters used to govern risk taking including detailed Structure of prudential limits
e. Strong MIS for reporting, monitoring and controlling risks;
f. Well laid out procedures, effective control and comprehensive risk reporting Framework;
g. Separate risk management framework independent of operational Departments And with clear delineation of levels of responsibility for management of risk; And
h. Periodical review and evaluation.

5.3.1 Risk Management Committee:

The primary responsibility of understanding the risks run by the bank and ensuring that the risks are appropriately managed should clearly be vested with the Board of Directors. The Board should set Risk limits by assessing the bank’s risk and risk bearing capacity.

At organizational Level, overall risk management should be assigned to an independent Risk Management Committee or Executive Committee of the top Executives that reports directly to the Board of Directors.

The purpose of this top-level committee is to empower one group with full responsibility of evaluating overall risks faced by the bank and determining the level of risks which will be in the best interest of the bank. At the same time, the Committee should hold the line management more accountable for the risks under their Control, and the performance of the bank in that area.

The functions of Risk Management Committee should essentially be to identify, monitor and measure the risk Profile of the bank. The Committee should also develop policies and procedures, verify the models that are used for pricing complex products, review the risk models as Development takes place in the markets and also identify new risks. The risk policies should clearly spell out the quantitative prudential limits on various segments of banks' Operations.

5.3.2 Credit Risk Management:

This risk is also known as default risk this is one of the prime basic non-systematic risk which is face by Indian bank from starting. This risk arises when there is debtors make default for paying loan landed them. The management of credit risk should receive the top management's attention and the process should encompass:

a. Measurement of risk through credit rating/scoring;
b. Quantifying the risk through estimating expected loan losses i.e., the amount of loan Losses that bank would experience over a chosen time horizon (through tracking Portfolio behavior over 5 or more years) and unexpected loan losses i.e., the amount by Which actual losses exceed the expected loss (through standard deviation of losses or The difference between expected loan losses and some selected target credit loss Quantile);
c. Risk pricing on a scientific basis; and
d. Controlling the risk through effective Loan Review Mechanism and portfolio Management.

Each bank has to set up separate credit Risk Management Department (CRMD), independent of the Credit Administration Department. The CRMD should enforce and monitor compliance of the Risk parameters and prudential limits set by the CPC. The CRMD should also lay down Risk assessment systems, monitor quality of loan portfolio, identify problems and Correct deficiencies, develop MIS and undertake loan review/audit.

Large banks May Consider separate set up for loan review/audit. The CRMD should also be made Accountable for protecting the quality of the entire loan portfolio. The Department should undertake portfolio evaluations and conduct comprehensive studies on the Environment to test the resilience of the loan portfolio.

5.3.3 Credit Approving Authority:

Each bank should have a carefully formulated scheme of delegation of powers. The Banks should also evolve multi-tier credit approving system where the loan proposals are approved by an 'Approval Grid' or a 'Committee'. The credit facilities above a Specified limit may be approved by the 'Grid' or 'Committee', comprising at least 3 or 4 officers and invariably one officer should represent the CRMD, who has no volume and profit targets.

Banks can also consider credit approving committees at various Operating levels i.e., large branches (where considered necessary), Regional Offices, Zonal Offices, Head Offices, etc. Banks could consider delegating powers for sanction of higher limits to the 'Approval Grid' or the 'Committee' for better rated / quality Customer.

5.3.4 Prudential Limits:

In order to limit the magnitude of credit risk, prudential limits should be laid down on various aspects of credit:

a. Stipulate benchmark current/debt equity and profitability ratios, debt service Coverage ratio or other ratios, with flexibility for deviations.
b. Single/group borrower limits, which may be lower than the limits prescribed by Reserve Bank to provide a filtering mechanism;
c. Substantial exposure limit i.e., sum total of exposures assumed in respect of those Single borrowers enjoying credit facilities in excess of a threshold limit,
d. Maximum exposure limits to industry, sector, etc.

5.3.5 Risk Rating:

Banks should have a comprehensive risk scoring / rating system that serves as a single point indicator of diverse risk factors of a counterparty and for taking credit decisions in a consistent manner. To facilitate this, a substantial degree of standardization is required in ratings across borrowers.

The risk rating system should be designed to reveal the overall risk of lending, critical input for setting pricing and non-price terms of loans as also present meaningful information for review and management of loan portfolio.

The risk rating, in short, should reflect the underlying credit risk of the loan book. The rating exercise should also facilitate the credit granting authorities some comfort in its knowledge of loan quality at any moment of time.

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5.4 Loan Review Mechanism (LRM):

LRM is an effective tool for constantly evaluating the quality of loan book and to bring about qualitative improvements in credit administration. Banks should, therefore, put in place proper Loan Review Mechanism for large value accounts with responsibilities assigned in various areas such as, evaluating the effectiveness of loan administration, maintaining the integrity of credit grading process, assessing the loan loss provision, portfolio quality, etc.

The complexity and scope of LRM normally vary based on banks'.

5.4.1 Non-Performing Asset:

As per Present convention, a non-performing asset refers to a loan or an advance where:

- Interest and/or installment of principal remain overdue for a period of more Than 90 days in respect of a term loan,
- The account remains 'out of order' for a period of more than 90 days, in Respect of an Overdraft/Cash Credit (OD/CC),
- The bill remains overdue for a period of more than 90 days in the case of bills Purchased and discounted,
- Interest and/or installment of principal remains overdue for two harvest Seasons but for a period not exceeding two half years in the case of an advance Granted for agricultural purposes, and
- Any amount to be received remains overdue for a period of more than 90 days

In respect of other accounts. Banks are required to classify their NPAs further into the following three categories Based on the period for which a specific asset has remained non-performing as well as the reliability of the dues:

Sub-standard assets refer to all those assets (loans and advances) which remain in the Non-performing category for a period of 12 months. Doubtful assets are the bank assets which remain in the non-performing category for a period exceeding 12 months. Finally, Loss assets refer to the class of bank assets which cannot be recovered at all.

5.4.2 Methods for Reducing Non-Performing Assets:

a. All accounts where interest has not been collected should be reviewed at periodical intervals by appropriate authorities, to fix repayment program for a term loan according to the income generating capacity of the unit.
b. After classification of unit as sick, bank can make decision to offer a rehabilitation package. In that case, bank has to have a sympathetic and positive approach and provide the relief package in time.
c. Merger is the process under which a sick unit is merged with a healthy unit, or sometimes, a healthy unit acquires a sick unit.
d. Recovery of advances through compromise settlement
e. If all attempts of converting an NPA into a performing asset fail, the bank is left with no other option but to recall the advance and resort to legal action by filing of recovery suits in the civil court or Debt Recovery Tribunals

5.5 Conclusion:

From study of risk management in the banks conclude that there are various types of Risk included in the banking business and banks have to deals with this it on daily basis there is ways to deals with it but with that needs proper risk management and human Intellectual to deal with it. Also, there is lots of RBI and regulatory authorities also to Deal with it that helps them to control and manage the risk. NPA plays an important role in the risk management of the bank. Lower the NPA higher the strong financial statement and strong reputation in the market and also attract the Investment from the world.

Banks has to control their NPA from time to time by way of recovering sum from the market which they lend in the market. Loan default risk is the primary risk in the banking industry.

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