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Research Paper

Risk Management in Public Sector Banks in India

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ABSTRACT

Risk is an uncertainty in any business. As such, banks are also not free from risky. Banks, especially public sector banks are always prone to risk, as they have to maintain liquidity, solvency and also make the profits by lending the loans to the general public. Hence, the risks are common in case of public sector banks. The various types of risks include systematic risks, operational risks, liquidity risks, credit risks are described. Further, to reduce these risks, there are different plans and decisions should be taken by the banks. Such plans of actions are discussed in the paper. It is concluded that there is need for a systematic plan and strategy to reduce the risk by the public sector banks in India, even with the help of external financial and legal agencies.

Keywords: Public Sector Banks, Risk Management, India

Introduction:

Banks are highly leveraged financial institutions that borrow fund mainly from the depositors which are mostly repayable on demand. They lend, from borrowed fund, to the borrowers. Here the underlying assumption is that the borrower will utilize the fund for business and will be able to generate sufficient surplus cash and will repay on time. Banks are in the business of taking risk. Given the nature of services that they provide, they are naturally placed for financial resources as deposits keep flowing in. The task gets complicated, as banks have to continuously deploy these resources to generate returns. On the asset side, the hunt is continuously on for quality assets, which are generally scarce in supply. On the other hand, quality assets being low risk also generate low returns. In order to generate higher returns, banks diversify into riskier areas.

In this way banks are always running a risk of insufficient liquidity as future is uncertain and borrower might default. Moreover, with the progressive reforms in the financial sector of the country characterized by greater liberalization and freedom, banks are having more liberty and thus in many cases increasingly exposing themselves to different kinds of risks. Risks in banking have also increased manifold due to several phenomena like globalization of banking services, introduction of wide range of banking products, complexity in banking operation, and increasing adoption of information technology in banks.

Risk can be defined as any uncertainty about a future event that threatens the organization's ability to accomplish its mission. The Oxford dictionary defines risk as "the possibility of loss, injury, disadvantage or destruction" But in the lexicon of banking business risk can be defined as: I. The probability of loss due to default of a customer or counter-party, 2. The probability of loss due to non-occurrence of events ass anticipated; and 3. The probability of loss due to occurrence of unexpected events. The loss due to the above causes may be financial or non-financial. It could also be expected loss or unexpected loss.

Characteristics of Risk:

A thorough understanding of characteristics of risk is essential to manage the same effectively. Risk is prelude exercise to Effective management of risk. In this connection the following features of risk are worth considerable:

v **Risk is always bad :**

Though risk is known as variation from expectation it is only the down side variation that is regarded as risk. Risk' is never applied with reference to good events. It is always attached to things that are bad. It is common to hear about the risk of heart attack from smoking; but not about the risk of wining a lottery, as the latter is perceived as something good/favorable. It is the loss that expected to be incurred due to the happening or non-happening of certain events or activities which are treated as risk and hence it connotation is always bad/ adverse.

v **Risk is Dynamic :**

Risk is not static. It keeps oscillating with time. A risk perceived today may disappear after sometime and similarly a no-risk/after a certain time. Risk simply keeps on migrating. It, thus, matters less where an organization starts in the risk co-ordinate system than how it changes overtime and in what specific direction it moves within the co-ordinate system.

Risk management in Banks:

Banking is nothing but financial intermediation. There are people in the market with surplus capital looking for safe investment opportunities. Simultaneously there are entrepreneurs desirous of building up productive assets but with no matching capital resource. Yet the 'savers' do not want to directly lend to capital seeking entrepreneurs as they are not certain of safety.

There can be no risk-free or zero risk oriented business. Risk in its pragmatic sense, therefore, involves both threats that may be materialized and opportunities which can be exploited.

The need for Credit Risk Rating has arisen due dismantling of State control, deregulation, globalization and allowing things to shape on the basis of market conditions; Indian Industry and Indian Banking face new risks and challenges. Competition results in the survival of the fittest. It is therefore necessary to identify these risks, measure them, monitor and control them. It provides a basis for Credit Risk Pricing i.e. fixation of rate of interest on lending to different borrowers based on their credit risk rating thereby

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balancing Risk & Reward for the Bank (Kaur, 2011).

Types of Risks in Public Sector Banks:

Santomero (1997) has listed the types of risks in public sector banks as under.

1. **Systematic** Risk or Market Risk: It is the risk of asset value change associated with systematic factors. It is sometimes referred to as market risk, which is in fact a somewhat imprecise term. By its nature, this risk can be hedged, but cannot be diversified completely away. In fact, systematic risk can be thought of as undiversifiable risk. All investors assume this type of risk, whenever assets owned or claims issued can change in value as a result of broad economic factors.
2. **Credit risk:** It arises from non-performance by a borrower. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. This can affect the lender holding the loan contract, as well as other lenders to the creditor. Therefore, the financial condition of the borrower as well as the current value of any underlying collateral is of considerable interest to its bank. The real risk from credit is the deviation of portfolio performance from its expected value. Accordingly, credit risk is diversifiable, but difficult to eliminate completely.
3. **Counterparty risk:** It comes from non-performance of a trading partner. The non-performance may arise from a counterparty's refusal to perform due to an adverse price movement caused by systematic factors, or from some other political or legal constraint that was not anticipated by the principals. Diversification is the major tool for controlling nonsystematic counterparty risk. Counterparty risk is like credit risk, but it is generally viewed as a more transient financial risk associated with trading than standard creditor default risk.
4. **Liquidity risk:** Liquidity risk can best be described as the risk of a funding crisis. While some would include the need to plan for growth and unexpected expansion of credit, the risk here is seen more correctly as the potential for a funding crisis. Such a situation would inevitably be associated with an unexpected event, such as a large charge off, loss of confidence, or a crisis of national proportion such as a currency crisis. In any case, risk management here centers on liquidity facilities and portfolio structure. Recognizing liquidity risk leads the bank to recognize liquidity itself as an asset, and portfolio design in the face of illiquidity concerns as a challenge.
5. **Operational risk:** Operational risk is associated with human error, system failures and inadequate procedures and controls. It is the risk of loss arising from the potential that inadequate information system; technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems may result in unexpected losses or reputation problems. Operational risk exists in all products and business activities. Operational risk event types that have the potential to result in substantial losses includes Internal fraud, External fraud, employment practices and workplace safety, clients, products and business practices, business disruption and system failures, damage to physical assets, and finally execution, delivery and process management.
6. **Legal risks:** Legal risks are endemic in financial contracting and are separate from the legal ramifications of credit, counterparty, and operational risks. New statutes, tax legislation, court opinions and regulations can put formerly well-established transactions into contention even when all parties have previously performed adequately and are fully able to perform in the future. For example, environmental regulations have radically affected real estate values for older properties and imposed serious risks to lending institutions in this area. A second type of legal risk arises from the activities of an institution's management or employees. Fraud, violations of regulations or laws, and other actions can lead to catastrophic loss, as recent examples in the thrift industry have demonstrated.

Risk Management in Public Sector Banks:

To manage risks in public sector banks, Naresh Kumar (2010) has suggested the following: 1) The directors in any bank should be more qualified than at present. 2) In order to manage the risk in Banks, the systems must be well defined and documented. A bank must focus on the development of sound system. 3) Every banking activity must be defined through a proper policy 4)The MIS should be strong and efficient in the banks. 5) Under the present system each controlling office zonal and Regional; office as the case may be is required to undertake visits to branches numbered from 30 to 40 once in a year. This number by itself is very large. Visiting officers is required to submit a report after visiting the branches and it is in the nature of a mini audit report. The banks need to revisit the whole system of branch visit.6) The banks have not yet started working out the Risk premium to be charged to a customer on a scientific basis as they don't have a historical data to support such calculation. 7) Risk Premium is booked by the banks as interest income.

Each of the above stated risks can be controlled and managed by taking appropriate measures as under.

1. **Systematic Risk Management:** First there is need to study the markets of different commodities and securities. They include foreign exchange reserves, shares, stocks, bonds, gold, etc. Further, there is also need to consider the regulations such as RBI guidelines from time to time, so as to fix margins. Based on these statistical information, it is possible to control and manage the systematic risks or market risks.
2. **Credit Risk Management:** A gap analysis should be made to establish the extent to which the bank's existing processes and procedures need to be enhanced to meet the demands of the new regulations. For this purpose, there is need to train the team of bankers and develop and strategic models and solutions with the help of experts or outside agencies. It is essentially needed to maintain record of every activity of the bank to manage the credit risks. As stated by Rekha Arunkumar (2005), better and effective strategic credit risk management process is a better way to manage portfolio credit risk. The process provides a framework to ensure consistency between strategy and implementation that reduces potential volatility in earnings and maximize shareholders wealth. Beyond and over riding the specifics of risk modeling issues, the challenge is moving towards improved credit risk management lies in addressing banks' readiness and openness to accept change to a more transparent system, to rapidly metamorphosing markets, to more effective and efficient ways of operating and to meet market requirements and increased answerability to stake holders. There is a need for Strategic approach to Credit Risk Management (CRM) in Indian Commercial Banks, particularly in view of;

(1) Higher NPAs level in comparison with global benchmark

(2) RBI' s stipulation about dividend distribution by the banks

(3) Revised NPAs level and CAR norms

(4) New Basel Capital Accord (Basel –II) revolution

3. Liquidity Risks : The responsibility for managing the overall liquidity of the bank should be delegated to a specific, identified group within the bank. A bank may form committee consisting management experts at the higher level and are experts in treasury management.

4. Operational Risks : A separate function independent of internal audit should be established for effective management of operational risks in the bank. Such a functional set up would assist management to understand and effectively manage operational risk. The function would assess, monitor and report operational risks as a whole and ensure that the management of operational risk in the bank is carried out as per strategy and policy.

5. Legal Risks : Managing legal risks requires the legal expertise. For this purpose, the banks may get assistance from other parties, who are expert legal advisors in controlling legal risks.

There is need to frame policies keeping in view the risk taking capacity of Banks as also the stated vision or goal to be achieved over a period. The Risk taking capacity of bank will have to take into account the profitability, capital adequacy, expertise available and sectoral and geographical strength of the bank. The policies must be well thought of document and should be made available at all levels.

Conclusion:

All of the above stated risks are threats for public sector banks in India. Of course, Reserve Bank of India is issuing guidelines from time to time to maintain solvency of each and every public sector banks. But, it is noted that internal management of each bank should be checked frequently against these possible risks. For this purpose, there is need for regular internal audit. It is also essential that the external credit and risk management agencies should be consulted by each of the public sector banks regularly so that each of these risks can be controlled and managed easily so as to maintain solvency of the banks and protect the interests of the depositors.

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