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Critical Analysis on Risk Management of Indian Commercial Banks in Context of Universal Banking

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Abstract – Banking is no longer a business restricted to borrowing and lending of funds. Recent years have seen Indian commercial banks – both in the public sector and private sector diversify into new areas to widen their business horizons. As banks started offering diversified services ranging from insurance to mutual funds, from stock-broking to housing finance, from merchant banking to portfolio management under one 'umbrella-brand', they gradually metamorphosed from being business organisations having prime focus on money transactions to a business related to information on financial transactions. Thus, with this transition, banks gradually moved towards becoming 'Universal banks'.

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. Like it or not, risk has a say in the achievement of our goals and in the overall success of an organization. Present paper is to make an attempt to identify the risks faced by the banking industry and the process of risk management. This paper also examined the different techniques adopted by banking industry for risk management. To achieve the objectives of the study data has been collected from secondary sources i.e., from Books, journals and online publications, identified various risks faced by the banks, developed the process of risk management and analyzed different risk management techniques. Finally it can be concluded that the banks should take risk more consciously, anticipates adverse changes and hedges accordingly, it becomes a source of competitive advantage, and efficient management of the banking industry. The regulatory framework would need to be strengthened so as to cover all aspects of Universal Banking either under control of one regulator or a coordinating mechanism would have to be developed among different regulators like the Reserve Bank of India, SEBI, Insurance Regulatory, Authority etc. The regulators will have to frame sound mechanism to protect the interests of all concerned including the customer, the Universal Banking Institution and the financial system of the country.

Key words: Risk management, Universal Banking, RBI and Commercial Bank.

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INTRODUCTION

Risk management in banking is theoretically termed as "the logical development and even the execution of a plan which actually deals with the potential losses". Usually, the actual focus of the risk management practices in the banking industry is to actually manage an institution's exposure who losses or risk and to actually protect the real value of its assets. In general banking business it is regarded as risky business. Economic theory also suggests that there are two economic units i.e. surplus unit and deficit unit -and these economic units actually prefer to use financial institutions (intermediaries) to transfer the necessary funds to each other. Certainly, this is the actual process which increases the importance of the financial intermediaries in the economy, but it also poses some risks to these institutions. Economic units are usually those who actually prefer to use the intermediaries because of the problems that are associated with and are asymmetric in nature. In order to solve the asymmetric information problems, various institutions are recruiting the

skilled employees and the systems, that is why the scarce sources of funds are now actually used more effectively by units in the economy.

UNIVERSAL BANKING:

Universal banks have long played a leading role in Germany, Switzerland, and other Continental European countries. The principal Financial institutions in these countries typically are universal banks offering the entire array of banking services. Continental European banks are engaged in deposit, real estate and other forms of lending, foreign exchange trading, as well as underwriting, securities trading, and portfolio management. In the Anglo-Saxon countries and in Japan, by contrast, commercial and investment banking tend to be separated. In recent years, though, most of these countries have lowered the barriers between commercial and investment banking, but they have refrained from adopting the Continental European system of universal banking. In the United States, in particular, the resistance to softening the separation of banking activities, as enshrined in the Glass-Steagall Act, continues to be stiff.

In Germany and Switzerland the importance of universal banking has grown since the end of World War II. Will this trend continue so that universal banks could completely overwhelm the specialized institutions in the future? Are the specialized banks doomed to disappear? This question cannot be answered with a simple "yes" or "no". The German and Swiss experiences suggest that three factors will determine future growth of universal banking.

First, universal banks no doubt will continue to play an important role. They possess a number of advantages over specialized institutions. In particular, they are able to exploit economies of scale and scope in banking. These economies are especially important for banks operating on a global scale and catering to customers with a need for highly sophisticated financial services. As we saw in the preceding section, universal banks may also suffer from various shortcomings. However, in an increasingly competitive environment, these defects will likely carry far less weight than in the past.

Second, although universal banks have expanded their sphere of influence, the smaller specialized institutions have not disappeared. In both Germany and Switzerland, they are successfully coexisting and competing with the big banks. In Switzerland, for example, the specialized institutions are firmly entrenched in such areas as real estate lending, securities trading, and portfolio management. The continued strong performance of many specialized institutions suggests that universal banks do not enjoy a comparative advantage in all areas of banking.

Universal banking is a system in which every bank provides in a wide variety of financial services, including both the commercial and investment services. Universal banking is mostly common in some European countries, including Switzerland.

In the United States, however, these banks are required to actually separate their commercial and investment banking services. Proponents of the universal banking also argue that it helps banks better to diversify the risk. Detractors think that dividing up the banks' operations is a less risky strategy.

TYPES OF RISK:

- **Credit Risk**

One of the main activities and an essential activity conducted by a bank is lending. When some of its credits are not actually returned to the bank when a customer also experiences financial problems, this is partially causing credit risk for the banks. This kind of financial loss results from the failure of credit customers to actually repay the banks.

- **Liquidity Risk**

Banks are also highly being focused on the problems of having insufficient liquid assets to actually compensate the cash needs or withdrawals from the depositors and the loan demands. Usually, it is maintaining the liquidity positions of the banks is termed as one of their crucial tasks, because the consequences of having a low level of liquidity can cause problems for the banks in terms of banking insolvency.

- **Market Risk or Systematic Risk**

Systematic risk is also related with the bank’s assets where their values are actually being changed by the systematic factors. It is also called as market risk and banks that are usually engaged in market activities. Market risk can also be related to any prices which are made continuously traded on the financial markets. Based on the theory of diversification, some of the investment risks can also be diversified away, but this is not actually possible with the rest.

- **Interest Rate Risk**

After deregulation occurred, most of the ceilings and restrictions on the interest rates were actually removed by the regulators and the authorities. Market interest rates are actually determined by the market dynamics. Nowadays, interest rates are also changing based on the supply and demand conditions. Under these circumstances, the movements of the interest rates which banks are

using for their activities also have various effects on the banks incomes and their expenses.

- **Earning Risk**

Earning risk is also related to a bank's net income, which is the last item on the income statement. Due to the changes in the competition level of the banking sector as well as the law and regulations, this could also cause a reduction in the bank's net income. Recent increases in banking competition may be narrow the spread between the actual return on bank assets and the cost of funding in bank liability.

- **Solvency or Default Risk**

Banks' at initial concerns about their institutions should be the long-term sustainability of this sector; this is also related to the solvency or default of banks. Two critical situations may also cause solvency problems, which are including when bank management have a significant amount of bad loans in the credit account, or even its portfolio investments substantially will decline in value and generate a severe capital loss.

BANKS ARE IN THE RISK BUSINESS

While the other banks are actually providing the financial services, they are also acting as a "middleman" in the transactions made, but this role is actually causing various kinds of risks to the other banks. Additionally, banks also use their own financial statements like their balance sheet to actually complete the transactions made and to absorb the risks which are associated with those activities. Usually, most of these risks that banks are facing in their business are on their balance sheet activities made. Therefore, the discussion and the necessary procedures for risk management are termed as centred on this area. Consequently, the balance sheet also includes the risk related to the bank's traditional and various trading activities.

REVIEW LITERATURE

According to Hundal B S; Jain Abhay (2006), In their article **"Adoption if Universal Banking Service in India"** has been published in The ICFAI Journal of Systems Management, Vol. IV No.2, pp. 63-72, which was articulated by stimulating and actually inhibiting various attributes on the adoption of the universal banking services and it outlines the managerial implications.

As per Migdadi Yazan K.A., ***" The Quality of Internet Banking Service Encounter in Jordan"*** , it also published in Journal of Internet Banking and Commerce, December 2008, Vol. 13, pp. 2-7 has made an attempt to actually identify the service quality between Jordan and UK. The evaluation of these banks web sites was conducted in March 2008 for 16 click-and-mortar retail banks in the UK and even 6 dot com retail banks in UK. Result indicated that, the internet banking service also encounter quality of the click-and-mortar in Jordan, retail banks is very closed in UK banks. Further quality of internet banking service will also encounter the quality of the click-and-mortar retail banks in the UK which are actually very close to the dot com and retail banks in the country UK.

According to Ipshita Bansal & Kamal K. Gupta, (2012), **"Development Of An Instrument To Measure Internet Banking Service Quality In India"** has also published in Journal of Arts, Science & Commerce, E-ISSN 2229-4686, ISSN 2231-4172 has made an attempt to actually develop a reliable and a valid instrument for measuring the Internet banking service quality in India, and it also analyzes the impact of Internet banking service quality dimensions on the Overall Internet Banking Service Quality and even customer satisfaction. Results of exploratory factor analysis (EFA) have revealed five dimensions— Security/Privacy, Reliability, Efficiency, Responsiveness, and Site Aesthetics.

As per **Nitsure Rupa Rege (2006)** In this book **"E-Banking: Challenges and Opportunities"**, E-Banking in India The Paradigm Shift, The ICFAI University Press, pp.3-16, she explained E-Banking has the actual potential to transfer the banking business as it is significantly lowers the transaction and the delivery costs.

OBJECTIVES OF STUDY

The following are the objectives of the study.

i. To identify the risks faced by the Banking Industry.

ii. To review the progress of Universal Banking in India.

iii. To trace out the process and system of Risk Management.

iv. To examine the techniques adopted by Banking Industry for Risk Management.

SIGNIFICANCE OF THE STUDY

The key findings of this study will be beneficial to the financial institutions of India. This study provides a good insight for the policy makers and after studying this study, they will be able to develop understanding regarding general risk management practices. Moreover, they will be also enabling to know, how the risk management practices influences the Financial Performance of Banks. This study will be of great beneficial for the manager especially at the time of framing risk management strategies. Apart from these, this

study will be of great useful for academia by adding information in existing body of literature.

RESEARCH PROBLEM

Analysis of Risk and its management has got much importance in the Banking Industry. The most important challenge faced by the banking industry today is the challenge of understanding and managing the risk. The very nature of the banking business is having the threat of risk imbibed in it. Banks' main role is intermediation between those having resources and those requiring resources. For management of risk at corporate level, various risks like credit risk, market risk or operational risk have to be converted into one composite measure. Therefore it is necessary that measurement of operational risk should be in tandem with other measurements of credit and market risk so that the requisite composite estimate can be worked out. So, regarding to international banking rule (Basel Committee Accords) and RBI guidelines the investigation of risk analysis and risk management in banking sector is being most important. In this context the following research question arises: Even though the risk is unavoidable can it be assessed properly and controlled? Are there any contingency plans to deal with risk if it occurs? How important is the study of risk management?

RESEARCH METHODOLOGY

The study is carried out to make qualitative and comprehensive evaluation of emerging and most preferred Universal Banking (UB) concept in India. For the purpose descriptive research design (observational method & case- study method) has been adopted which is based on the secondary data and the secondary sources of data were the various websites, published annual reports and literatures of the banking companies, RBI annual report, Publications of Public sector banks, IMF annual & periodical reports and academic journals.

The present study is of analytical and exploratory nature. Accordingly, the use it is made of primary data. The key intention of the study is to evaluate the security and infrastructure measures of Universal banking adopted so far to avoid risk management.

Types of Risk: Overall banking activities create many unique risks, but in this case, various examples can be given to simplify the introduction. These risks are related to a bank's credits, liquidity, trading, revenues and costs, earnings and solvency issues.

a. **Credit Risk:** One of the main activities conducted by a bank is lending. When some of its credits are not returned to the bank when a customer experiences financial problems, this is partially causing credit risk for the banks. This kind of financial loss results from the failure of credit customers to repay the banks.

b. **Liquidity Risk:** Banks are also highly focused on the problems of having insufficient liquid assets to compensate the cash needs or withdrawals from depositors and loan demands. Usually, maintaining the liquidity positions of the banks is one of their crucial tasks, because the consequences of having a low level of liquidity cause problems for the banks in terms of banking insolvency. Solvency is related to the obligations that banks are primarily giving promises to their customers. Faced with liquidity problems, the banks need to borrow funds immediately with extra cost in order to meet their cash needs. This kind of funding is usually done by the lender of last resort or interbank markets. Immediate fund needs can be covered by the central banks or other sources, but this process leads to additional costs for the banks and reduces their earnings.

c. **Market Risk or Systematic Risk:** Systematic risk is related with the bank's assets where their values are changed by the systematic factors. It is also called market risk and banks are usually engaged in market activities. Market risk can be related to any prices which are continuously traded on the financial markets. Based on the theory of diversification, some of the investment risks can be diversified away, but this is not possible with the rest. Certainly, new opportunities like hedging provide the opportunity for market participants to hedge their risk, but this is not completely diversified away from the risks that are related to the market.

d. **Interest rate Risk:** After deregulation, most of the ceilings and restrictions on the interest rates were removed by the regulators and authorities. Market interest rates are determined by the market dynamics. Now a day, interest rates are changing based on the supply and demand conditions. Under these circumstances, movements of the interest rates which banks are using for their activities also have effects on the banks incomes and expenses. Some of the banks' assets are generating interest revenues such as loans and security investments, while on the other hand, some liabilities also have expenses like deposits. Therefore, the changing interest rates have had a substantial impact on the banks' profits.

Consequently, this is called interest rate risk.

e. **Earning Risk:** Earning risk is related to a bank's net income, which is the last item on the income statement. Due to changes in the competition level of the banking sector as well as the law and regulations, this could cause a reduction in the bank's net income. Recent increases in banking competition may narrow the spread between return on bank assets and the cost of funding in bank liability.

f. **Solvency Risk:** Banks' initial concerns about their institutions should be the long-term sustainability of the sector; this is related to the solvency or default of banks. Two critical situations may cause solvency problems, including when bank management has a significant amount of bad loans in their credit account, or when its portfolio investments substantially decline in value and generate a severe capital loss.

PROCESS OF RISK MANAGEMENT:

Step 1: Risk Identification - Identify Risks Understand and Analyze Risks

Step 2: Risk Assessment and Measurement - Assess the Risk Impact Measure the Risk Impact

Step 3: Risk Control - Recommendations for Risk Control Risk Mitigation through Control Techniques Deputation of Competent Officers to Deal with the Risks

Step 4: Risk Monitoring - Supervise the Risks Reporting on Progress Compliance with Regulations Follow-up.

Step 5: Risk-Return Trade-Off -Balancing of Risk against Return.

ANALYSIS OF RISK MANAGEMENT

1. 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.

Value at Risk (VaR) : It is one of the newer risk management tools. 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.

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.

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.

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

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assumed. By creating a given set of scenarios, the analyst can determine how changes in one variable(s) will impact the target variable.

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.

FINDINGS OF RESEARCH:

The following are the findings drawn from the study.

1. 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.

2. 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.

3. Functions of risk management should actually be bank specific dictated by the size and quality of balance sheet, complexity of functions, technical/ professional manpower and the status of MIS in place in that bank.

4. Risk Management Committee, Credit Policy Committee, Asset Liability Committee, etc are such committees that handle the risk management aspects.

5. 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.

6. Regarding use of risk management techniques, it is found that internal rating system and risk adjusted rate of return on capital are important.

RESEARCH RECOMMENDATIONS

Policy Recommendations Based upon study results following are the key recommendations must bearing in mind while dealing with risks management;

1. It is suggested that commercial banks of India should fully concentrate on the loan assessment procedure, polices and quality of loans, liquidity management as well as to mitigate the shocks confronted due to interest rate risk.

2. Banking companies need to take a critical look at their risk management strategies. Moreover, companies must ensure that they have recognized those risks and vulnerabilities that could washout overall businesses strategies and operations.

3. Risk management cannot be a onetime activity. It is an ongoing process. It is also recommended Indian banking industry should inculcate a balance risk management culture. There should be risk based strategy formulation.

4. There should be mature corporate governance framework having balance of expertise to cope with governance risk. It is crystal clear in developing companies have cruel governance structure. Hence, all banks management must have well thought-out risk mitigation mechanisms. There should be periodic review of risk based strategies as well risk management departments expertise.

RESEARCH CONCLUSION:

Thus, as risk is indispensable for banking business, proper assessment of risk is an integral part of a bank's risk management system. Banks are focusing on the magnitude of their risk exposure and formulating strategies to tackle those effectively. In the context of risk management practices, the introduction of Basel norms and its subsequent adoption by RBI is a significant measure that promises to promote sound risk management practices. BASEL Accord seeks to enhance the risk sensitivity of capital requirements, promote a comprehensive coverage of risks, offer a more flexible approach through a menu of options, and is intended to be applied to banks worldwide.

Moreover, the RBI has adopted a series of steps to ensure that individual banks tackle risks effectively by setting up risk management cells and also through internal assessment of their risk exposure. Apart from this, RBI has opted for on-site and off-site surveillance methods for effective risk management in the Indian Banking sector, so that systemic risk and financial turmoil can be averted in the country.

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