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A Study of Risk Management Systems in Banks

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Abstract

A major issue in establishing an appropriate risk management organisation structure is choosing between a centralised and decentralised structure. The global trend is towards centralising risk management with integrated treasury management function to benefit from information on aggregate exposure, natural netting of exposures, economies of scale and easier reporting to top management. 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 organisational 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.

key words: Risk, Management, Organisation, Bank, Independent etc.

Introduction

The risk management is a complex function and it requires specialised skills and expertise. Banks have been moving towards the use of sophisticated models for measuring and managing risks. Large banks and those operating in international markets should develop internal risk management models to be able to compete effectively with their competitors. As the domestic market integrates with the international markets, the banks should have necessary expertise and skill in managing various types of risks in a scientific manner. At a more sophisticated level, the core staff at Head Offices should be trained in risk modelling and analytical tools. It should, therefore, be the endeavour of all banks to upgrade the skills of staff. Currently, while market variables are held constant for quantifying credit risk, credit variables are held constant in estimating market risk. The economic crises in some of the countries have revealed a strong correlation between unhedged market risk and credit risk. Forex exposures, assumed by corporates who have no natural hedges, will increase the credit risk which banks run vis-à-vis their counterparties.

Types of risk

- **Liquidity risk:**

Liquidity is a bank's ability to meet its cash and collateral obligations without sustaining unacceptable losses. Liquidity risk refers to how a bank's inability to meet its obligations. It threatens its financial position or existence. Institutions manage their liquidity risk through effective asset liability management (ALM).

- **Interest rate risk:**

Interest rate risk in the banking book (IRRBB) refers to the current or prospective risk to the bank's capital and earnings arising from adverse movements in interest rates that affect the bank's banking book positions. When interest rates change, the present value and timing of future cash flows change. This in turn changes the underlying value of a bank's assets, liabilities and off-balance sheet items and hence its economic value. Changes in interest rates also affect a bank's earnings by altering interest rate-sensitive income and expenses, affecting its net interest income (NII).

- **Market risk**

The Basel Committee on Banking Supervision defines banks' market risk as "the risk of losses in on- and off-balance sheet risk positions arising from movements in market prices."

The major components of a bank's market risk include:

- Interest rate risk
- Equity risk
- Foreign exchange risk
- Commodity risk

Default risk or credit risk

It occurs when borrowers or counterparties fail to meet contractual obligations. An example is when borrowers default on principal or interest payment of a loan. Credit risk can be classified as counterparty risk and country risk

Counterparty Risk: This arises when the counterparty is unable to perform its side of transaction.

Country Risk: This is the risk of non-performance a counterparty due to restrictions imposed by a country

- **Operational Risk:**

Operational risk is the risk of loss due to errors, interruptions, or damages caused by people, systems, or processes. E.g. Losses that occur due to human error include internal fraud or mistakes made during transactions. Employee embezzlement is an example of operational risk.

- **Banks' reputational risk:**

Reputational risk is the risk of damage to a bank's image that occurs due to some dubious actions taken by the bank. Sometimes reputational risk can be due to perception or negative publicity against the bank, without any solid evidence of wrongdoing. Reputational risk leads to the public's loss of confidence in a bank.

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conclusion

The Basel III amendments have been created and nations are working to develop the new components into the old version by 2027. In the previous version, there were three pillars and this application determined the system for the banks to manage the risk that occurred in their activities. With the new version, the liquidity issue started to be considered by authorities to eliminate the liquidity problems at the bank level. With the global crises that started in 2007, all the market participants witnessed the bankruptcy of large banks in developed countries. With the new Basel III application, BIS started to consider the liquidity and other issues to increase the health of the countries' banking industry.

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