

RISK MANAGEMENT FOR BANKS

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Volatility of global markets, technological advancements, innovative new financial products and changing regulatory environments have made risk management a critical task for financial institutions today as they simultaneously mitigate and create risks.

It has, therefore, become increasingly important to identify, measure, monitor and manage a financial institutions' exposure to product-market and capital-market risks. In capital-market a firm transacts with owners and lenders and is exposed to interest rate, liquidity, currency, settlement and basis risks. In the product market it transacts with clients and suppliers. This may result in credit, strategic, regulatory, operating, commodity, human resources, legal and product risks.

Risk is simply uncertainty. It is not only the incidence of adverse outcomes but unforeseen favourable outcomes are also a form of risk. Foregoing opportunities is as significant as actual losses. Risk can be avoided by not undertaking transaction (s) that carries risk. It can be reduced through actions that lower the severity of loss. It can be retained by accepting the loss when it occurs. It can be transferred by causing another party to accept the risk. All risks that are not avoided or transferred are retained by default.

The business of financial institutions, as intermediaries, is essentially the business of bearing risk for a price. Without accepting risk there is little reason for their existence. However, any risk that compromises the survival of the firm cannot be adequately compensated. Equilibrium between risk and return must be maintained. Recognizing both the potential value of opportunity and the potential impact of adverse effects is of immense importance. It requires forward planning approach, identifying uncertainties, anticipating potential outcomes and making risk management an integral and vital part of strategic management.

Financial institution functions within legal and regulatory constraints that limit then risk management alternatives. The State Bank of Pakistan is the regulatory authority of financial institutions operating in Pakistan.

The State Bank through a circular on "Risk Management Guidelines for Commercial Banks & DFI'S" followed by a continuing series of seminars advised the

financial institutions in Pakistan to commence setting up independent divisions along the lines stipulated by the Bank for International Settlements (BIS), based in Basel. The gist of the SBP circular is as follows:

Risk management involves identification, measurement, monitoring and controlling risks ensuring that,

- i. The individuals who take or manage risks clearly understand it
- ii. The organization's risk exposure is within the limits established by its Board of Directors (BOD).
- iii. Risk taking decisions are in line with the business strategy and objectives set by BOD
- iv. The expected payoffs compensate for the risk taken
- v. Risk taking decisions are explicit and clear
- vi. Sufficient capital as a buffer is available to justify the level of risk exposure.

The acceptance and management of financial risk is inherent to the business of banking and banks' roles as financial intermediaries. Risk management as commonly perceived does not mean minimizing risk; rather the goal of risk management is to optimize the risk-reward trade-off. Notwithstanding the fact that banks are in the business of taking risk, it should be recognized that an institution need not engage in business in a manner that unnecessarily imposes risk upon it: nor should it absorb risk that can be transferred to others.

In every financial institution, risk management activities broadly take place simultaneously at the following different hierarchy levels

Strategic Level: This encompasses risk management functions performed by senior management and BOD.

Macro Level: This encompasses risk management within a business area or across business lines. Generally the risk management activities performed by middle management of units devoted to risk reviews fall into this category.

Micro Level: This involves 'on-the-line' risk management where risks are actually created. This covers the risk management activities performed by individuals who take risk on the organization's behalf such as front office and loan origination functions.

There are four major types of risk, which any financial institution has to face, they are:

- i. Credit Risk
- ii. Market Risk
- iii. Liquidity Risk
- iv. Operational Risk

Credit Risk

Credit risk arises from the potential that an obligor is either unwilling to perform on an obligation or its ability to perform such obligation is impaired resulting in economic loss to the bank.

Historically, credit risk has been the risk causing major losses to banks operating in Pakistan. The Board of Directors is responsible for formulating a well-defined credit policy. The senior management needs to develop policies, systems and procedures and establish an organizational structure to measure, monitor and control credit risk, which should also be duly approved by the board. The bank should also put in place a well-designed credit risk management setup commensurate with the size and complexity of their credit portfolio. The loan origination function is of key importance, which necessitates the need for proper analysis of the borrower's creditworthiness and financial health. This aspect is reinforced by the credit administration function that not only ensures that activities conform to a banks' policies and procedures, but also maintains credit files, loan documents and monitors compliance of loan covenants. The banks are encouraged to assign internal credit ratings to individual credit exposures. The architecture of such a rating system may vary among banks. The loan portfolio should be monitored regularly and a report prepared at periodic intervals both for the aggregates as well as sectoral and individual loan levels. Finally, banks are required to formulate a strategy/action plan to deal with problem loans.

Market Risk

This is the risk that the value of the on and off-balance sheet positions of a financial institution will be adversely affected by movements in market rates or prices such as interest rates, foreign exchange rates, equity prices, credit spreads and / or commodity prices resulting in a loss to earnings and capital. Notwithstanding the fact that the board and senior management should develop the bank's strategy and transform those strategies by establishing policies and procedures for market risk management, a robust risk management framework is an important element to manage market risk. Such a framework includes an organizational setup commensurate with the size and nature of business, and system and procedures for measurement, monitoring and mitigating/controlling market risks. Ideally, the hierarchical structure includes an ALCO (Asset Liability Committee) headed by the CEO of the bank, which may provide updates of Board of Director's Sub-committee on Risk Management. Further, banks should establish a mid office between front office and bank office functions. This unit should manage risks relating to treasury operations and report directly to senior management. There is a vast array of methodologies to measure market risk, ranging from static gap analysis to sophisticated risk models. Banks may adopt various techniques to measure market risk, as they deem fit. Finally, the banks should ensure that they have adequate control mechanisms and appropriate setup such as periodic risk reviews / audits etc to monitor market risk.

Liquidity Risk

Liquidity risk is the potential for loss to an institution arising from either its inability to meet its obligation or to fund increases in assets as they fall due without incurring unacceptable cost or losses.

As the impact of such risk could be catastrophic, the senior management needs to establish a mechanism to identify, measure and mitigate/control liquidity risk. The senior management should also establish an effective organization structure to continuously monitor the bank's liquidity. Generally, the Bank's BOD constitutes a committee of senior management known as ALCO to undertake the function. Key elements of a sound liquidity management process include an effective Management Information System, risk limits and development of a contingency funding plan.

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, systems and people or from external events. Besides establishing a tolerance, level for operational risk, the BOD needs to ensure that the senior management has put in place adequate systems, procedures and controls for all significant areas of operations. Further, the management of the bank should effectively communicate laid down procedures / guidelines down the line and put in place a reasonable set up to implement the same.

Two major risks that the SBP guidelines ignore are human resources and reporting risk. Human resources are the most valuable assets of any organization. The departure of an employee with specialized knowledge can bring certain systems to a halt. The Bank of Credit and Commerce International was liquidated only when Agha Hassan Abedi was incapacitated. . Disastrous actions were necessitated against Mehran Bank and Indus Bank only because of failure to report problems and policy inconsistencies on time.

Exaggerated values of assets and liabilities, accumulation of colossal bad debts and resultant failed policies were mainly because of failure in reporting of real values.

Failure to retain employees is a bad indicator of overall bank management - responsibility that rests with the board of directors. Basle Accord-II requirement that banks hold adequate capital to provide for every risk, without concessions for portfolio diversification, will squeeze bank profits.

A likely scenario is that Basel Accord-II requirements may push banks into finding ways of passing many of their risks on to other market players. This harsh reality, which recently surfaced in some European countries, amounted to transferring risk from institutions (banks) that had greater credit expertise and long standing relationships with their borrowers, on to institutions that were ill equipped for managing it.

For the moment, such a development seems a remote possibility in Pakistan because insurance companies don't cover even some of the insurable risks. But nevertheless, it is a possibility. Should that happen risk will not evaporate; it will start

accumulating in less regulated sectors, with eventual consequences that could be as damaging as the failure of co-op banks and investment companies was during the 1990s?

The present accounting system is based on historical costs and accruals. As a result changes in economic values are not reflected in reported value of financial statements. The second problem relates to the dimensionality of risk exposure. Even if a full market value accounting system were employed the income statement will capture only ex-post changes in assets and liabilities values and not ex-ante risk exposure.

The SBP through its circular No BSD-17 of November 26, 2004 allowed Banks and DFI's to undertake derivatives business provided they met the eligibility criteria and had obtained Authorized Derivatives Dealer or Non-Market Maker Financial Institutions status from the SBP.

A derivative is a financial instrument, which is erratically a promise to convey ownership. All derivatives are based on some underlying cash and real product. These cash products are:

- i.** Spot Foreign Exchange Rates
- ii.** Commodities
- iii.** Equities
- iv.** Bonds
- iv.** Money-market negotiable debt securities
- v.** Over the counter money market product Options, futures forwards and swaps.

The SBP through circular BSD-17 allowed dealings in

- i.** Foreign currency options
- ii.** Forward Rate Agreement
- iii** Interest Rate Swaps.

Foreign currency options are permitted in G-7 currencies only no entity may offer any PKR/USD or PKR/other currency options unless specifically permitted by SBP. There is no restriction on the minimum or maximum size of "notional principal amounts of FX options. However, tenor is limited to a maximum of one year. All exposures must be covered on back-to-back basis from a foreign bank or local banks' branches abroad.

Dealing in forward rate agreement is permitted in Pak Rupees only. There is no restriction on the size of notional principal. However tenure is limited to maximum of two years. Interest rate swaps are permitted in Pak Rupees only. There is no restriction on the size of notional principal but tenor is limited to a maximum of 5 years.

Banking sector in Pakistan has experienced profound changes over last decade. Since 2002 there has been a significant rapid increase in bank profitability. The commercial banking sector in Pakistan has come of age and is now well equipped in

terms of technology, skills and financial resources to play an effective role in financial intermediation. With the privatization of HBL, 80% of banking business has now come under private management and the already competitive environment has become even more intense.

With declining spreads in corporate finance, banks are increasing their focus on other segments, e.g. the SME sector and consumer finance. While this shift is expected to preserve declining margins, it also exposes the banks to higher level of risk. The increase in risk / reward appetite would obviously require more stringent risk management system for preserving asset quality. While there is a general improvement in risk management system across the banking sector, there is less than adequate sensitivity about ensuring that the risk appetite remains consistent with the capacity of individual banks to manage it.

In Pakistan, most of the financial institutions have separate risk management department. They are working on managing all types of risk but are lacking for behind in the use of financial mathematics, financial engineering and information technology to measure and monitor financial risk.

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