A Study of Risk Management On Financial Performance of the Indian Banking System

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Abstract

The main aim of this study is to look or focus on the risk management of the Indian banks of public and private area, investigate the impact of market risk on the financial performance of the chose banks, to survey the asset quality of the banks by assessing the credit risk, to determine the risk exposure for assessing the performance of selected banks and investigate the financial statements with respect to the credit and market risk. Risk management is the identification, appraisal, and prioritization of risks followed by facilitated and economical utilization of resources to limit, screen and control the probability and effect of unfortunate events. Deposit money banks expect different sorts of risks during the time spent offering financial types of assistance as loaning is the center business action of banks. The advance portfolio is commonly the biggest resource and the overwhelming source of revenue to banks and furthermore probably the best source of risk to a bank's safety and soundness. At the center of credit augmentation in the banking business risk management is viewed as the cycle of recognizing risks, surveying their suggestions, settling on a strategy, and assessing the outcomes. Effective risk management tries to augment the advantages of a risky circumstance while limiting the negative impact of the risk. Sufficient management of credit risk in financial organizations is basic for their endurance and development. To achieve this, the bank management should have exhaustive information on every portfolio composition or mix, industry and geographic convergences of credits, normal risk appraisals, and other aggregate characteristics. They should be certain that the approaches, cycles, and practices actualized to control the risks of individual advances and portfolio sections are sound and that loaning work force stick to them.

Keywords: *Risk Management, Indian Banks, Public and Private Area, market risk, financial performance.*

1. INTRODUCTION

The Indian banking system has undergone significant structural transformation since the 1990s. An administered regime under state ownership until the initiation of financial sector reforms in 1992, the sector was opened to greater competition by the entry of new private banks and more liberal entry of foreign banks in line with the recommendations of the Report of the Committee on the Financial System. During this period, ownership in public sector banks was also diversified. The Reserve Bank of India is the regulator and supervisor of the banking system in India and is entrusted with the task of framing the capital adequacy guidelines for banks in India under Basel II. The Reserve Bank of India has clearly articulated the approach for implementation of Basel II for commercial banks in India. Under these guidelines all the commercial banks would be Basel II compliant in 2009 with regards to the revised capital adequacy. Public sector banks, where the Government of India is the major shareholder, dominate the Indian banking system, accounting for nearly three-fourths of total assets and income. These banks are large and very old banks, operating through thousands of branches spread all over the country. The private sector banks consist of nineteen old banks, which are small in size and scale and eight new private sector banks, which were set up in the mid-1990s with the onset of liberalization. The new private sector banks are fully automated from day-one and operate like other high-tech foreign banks. The private sector banks have grown rapidly since the onset of reforms and have increased their share in total assets of the banking industry from 7.7% in 1996 to 20.5% in 2006, whereas the public sector banks have witnessed a shrinkage in market share from 84.4% to 72..3% in the same period. Public and private sector banks also differ with respect to their background and work culture. It has been observed that the work culture of public sector banks was based on the concept of socio-economic responsibility, in which profitability is secondary. On the other hand, private sector banks work towards profitability. Because these differences between the two banking sectors one can expect differences in their risk management strategies. The banking sector continues to embrace innovations and as a result, the intensity and variety of risks that the banks are exposed continue to increase in tandem. To ensure that the growth in the banking sector does not jeopardize the stability of the financial sector, risk management becomes crucial. In view of this, a survey was carried out to assess the awareness of risk management policies employed at branch level in order to find out if there are any differences between the public and private sector banks.

2. CONCEPT OF RISK

In the financial world, risk can be characterized as "any occasion or plausibility of an occasion which can debilitate corporate profit or cash stream over short/medium/long haul skyline." Corporate income or cash streams have a course on the abundance of the investors through valuation of the partnership.

As such, the potential for future re-visitations of change from the normal returns is risk. On the off chance that profits could be ensured under all conditions, there would be no risk, and risk management would be unimportant. Nonetheless, such an assurance is beyond the realm of imagination in reality; henceforth, the requirement for risk management.

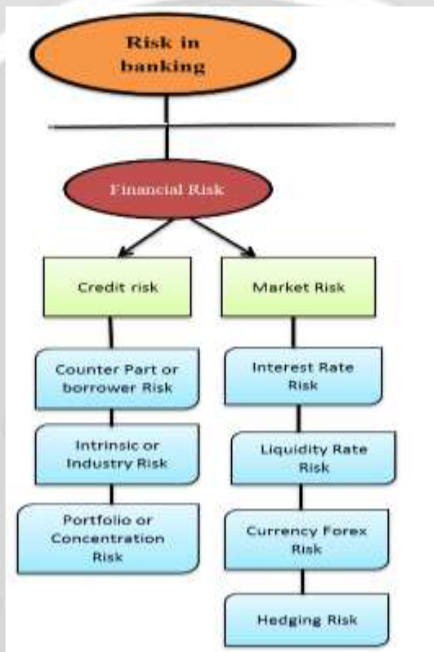

Figure 1: Risk in Banks

All associations manage risks; however the nature and extent may contrast for each kind of association. This is particularly valid for banks/financial foundations, as they manage cash. They go about as financial go-betweens in any monetary framework. They help in preparing family/corporate investment funds and making them accessible to shortfall units. Since they help in credit creation through advances and advances, they face numerous risks. Truth be told, facing challenge is the center of the large portion of the items and administrations offered by banks/financial organizations.

Risk can be characterized as probability of misfortune emerging due to vulnerability of result of a specific transaction. Banks and financial foundation have consistently managed risks and vulnerabilities, and the target of risk management is to limit misfortunes emerging from such risk openings.

Risks are viewed as justified when they are reasonable, quantifiable, controllable and inside a banking and financial establishment's ability to promptly withstand unfavorable outcomes. Sound risk management frameworks empower directors of banking and financial foundations to face challenges intentionally, diminish risks where suitable and endeavor to plan for a future, which by its temperament can't be anticipated with outright assurance. Risk Management is an order at the center of each banking and financial organization and includes all exercises that influence its risk profile. Administrators of banking foundations ought to connect significant significance to improve the capacity to recognize measure, screen and control the general risks expected.

3. RISK MANAGEMENT AND BANK PERFORMANCE

A significant goal of bank management is to expand shareholders' return embodying bank execution. The goal frequently comes at the expense of expanding risk. Bank faces different risks, for example, interest risk, market risk, credit risk, reeling risk, innovation and operational risk, foreign trade risk, country risk, liquidity risk, and indebtedness risk. The bank's inspiration for risk management comes from those risks which can prompt bank underperformance.

Issues of risk management in banking area have more prominent effect on the bank as well as on the economic development. Tai (2004) reasons that some observational proof demonstrates that the previous return stuns exuding from banking area have huge effect not just on the volatilities of foreign trade and aggregate financial exchanges, yet in addition on their costs, recommending that bank can be a significant source of disease during the emergency.

Banks which better execute the risk management may have a few points of interest: (i) It is in accordance with submission work toward the standard; (ii) It expands their standing and freedom to draw in more wide customers in building their portfolio of asset resources; (iii) It expands their productivity and benefit. The more prominent credit accessibility prompts the chance to expand the beneficial assets and bank's benefit.

Effect of Risk Diversification on Financial Performance of the Bank

This includes spreading interests into a more extensive scope of financial administrations or loans; business, individual, credit cards, home loan, auto and instructive loans. Broadening decreases both potential gain and disadvantage potential and takes into account more predictable execution under a wide scope of financial conditions. Broadening can be performed across items, enterprises and nations. Enhancement system presumably happens, when go with or business associations present another item on the lookout. In mid-1960 and 1970's there is quick development in enhancement of organizations. Be that as it may, with the progression of time it got hard to oversee a lot of differentiated exercises of business association. Indeed, even lately, it is very hard for any business association to work in expansion mode in light of the fact that there are various necessities that should be considered by the business association. Loan portfolio risk can be decreased with a viable credit survey of candidates and particular resource backing.

Risk Appraisal and Financial Performance

Credit risk examination is the interaction by which the loan specialist evaluates the credit value of the borrower. Methods of credit evaluation: It rotates around character, insurance ability and limit. It considers different elements like pay of the candidates, number of wards, month to month consumption, reimbursement limit, business history, number of long stretches of administration and different variables which influence credit rating of the borrower. The evaluation of the different risks that can effect on the reimbursement of loan is credit examination. Contingent upon the motivation behind loan and the quantum, the evaluation interaction might be straightforward or expound. For little close to home loans, credit scoring dependent on pay, way of life and existing liabilities may get the job done. Yet, for project financing, the interaction involves specialized, business, marketing, financial, administrative examinations as additionally execution timetable and capacity. The credit risk evaluation implies measures utilized by banks to keep away from or limit the unfavorable impact of credit risk.

Risk Control Techniques in the Bank

Credit control is the framework utilized by a business to ensure that it gives credit just to clients who can pay, and that clients pay on schedule. Credit control is important for the financial controls that are utilized by organizations especially in assembling to guarantee that whenever deals are made, they are acknowledged as cash or fluid assets. The institutional needs, customs and methods of reasoning's encompassing loaning or credit choices assume a more significant part than any time in recent memory in loaning foundations Dasah. Contemplating the mind boggling and broad nature of the banking industry, it is fundamental for note that credit control accepts every one of the variables identified with credit quality, credit expansion, and repetitive repeating examples and groupings. Additionally, a trained and solid credit control addresses the establishment of credit risk management since it directs all the credit and finishing choices.

Extra (nonfinancial) risk types are arising

Although management of financial risks has progressed fundamentally in the course of the most recent 20 years, this isn't the situation for other risk types, especially nonfinancial ones. The enormous expansion in fines, harms, and legal costs identified with operational and consistence risk in the course of recent years has constrained banks to give substantially more consideration to these risks. This will likely increment considerably further, because of the administrative trends talked about before and given the normal ascent in capital prerequisites for operational risk.

As though this were sufficiently not, other essential risk types have been arising. Models incorporate the accompanying:

- **Contagion risk**

Financial and macroeconomic connectedness makes economies, companies, and banks more defenseless against financial infection. Negative market advancements can spread to different pieces of a bank, different business sectors, or included gatherings and can make a bank's working climate decay rapidly and altogether. This can happen locally and across borders, in view of worldwide capital streams and the globalization of finance. The more firmly associated the business sectors, the more rapidly instability spreads. Albeit national banks are the essential substances that stress over disease risk, singular banks need to see how they can be presented to it. Banks need to gauge and track it. Diminishing this risk can decrease the bank's complete risk and lower its capital prerequisites, in light of the fact that a bank's exposure to disease risk is one of the fundamental hidden drivers for its arrangement as a worldwide foundationally significant bank (G-SIB) and for G-SIB capital extra charges.

- **Model risk**

Banks' expanding reliance on models necessitates that risk administrators better comprehend and oversee model risk. Expanded information accessibility and advances in registering, demonstrating, and calculations have extended model use. Be that as it may, mistakes from problematic models can prompt helpless dynamic and increment banks' risks. A few banks have encountered model-risk-related misfortunes, albeit the majority of these cases are not announced freely. For example, one huge US bank had misfortunes of $6 billion, which were halfway because of value at-risk model risk (i.e., absence of displaying experience by the administrator, no back-testing, and operational issues in the model).5 In another model, a huge Asia–Pacific bank lost $4 billion when it dishonestly applied financing cost models—for instance, through mistaken presumptions, information passage blunders, and breakdowns and mistakes in the models. Model blunders originate from issues with information quality, calculated robustness, specialized or execution mistakes, connection or time irregularities, and vulnerabilities about unpredictability. There are various alleviation methodologies, which focus on more thorough, refined model turn of events, better execution (with more excellent information), careful approval, and steady checking and improvement of the model.

- **Cyber attacks**

Most banks have effectively made assurance against cyber-attacks a top vital need, as these assaults can have destroying outcomes. This is part of the way because of the banks' substantial dependence on programming, frameworks, data innovation (IT), and information, yet in addition to the way that that these assaults would risk the banks' activities as well as secret client information. Given the current geopolitical setting and its possible development, we expect network protection just to increment in significance and require a considerably more prominent organization of assets at the individual-establishment level, just as a lot more note value cross industry and industry-government coordinated effort. Risk capacities will no doubt require new abilities and cycles to oversee and follow these arising risks.

4. RISK MANAGEMENT IN INDIAN BANKING SYSTEM

Risk Management is the way toward distinguishing, measuring, and focusing on risks followed by a picked key activity for practical usage of assets to follow, lessen, and control the likelihood as well as expected effect of terrible occasions. Accordingly risk management can make the likelihood of an awful occasion decrease, or it can help limit the outcomes if there should arise an occurrence of a sad occasion.

The Indian banking industry is a thickly managed with nitty gritty and centered controller like Reserve Bank of India. On one hand the Indian banks face a test to stay aware of the adjustments in the guidelines by RBI, anyway then again RBI faces a test to proficiently direct the Indian banking industry with convenient dispatch of compelling policies. The Indian Banks oversee risks related with tolerating stores, allowing loans and exchanging portfolios. The powerfully changing monetary climate essentially affects Indian Banks and now and again it doubts the capacity of the Indian Banks to utilize their assets cautiously as they neglect to adequately deal with their financing cost spread inferable from low loan costs on loans and high rivalry for stores. Indian Banks now and again battle to adapt up to changing industry trends and monetary vacillations.

Bank Management's disappointment is straightforwardly spotted by their investors when it brings about misfortunes attributable to over-forceful loans assents and distributions to basically build the loan book by recognizing risk resiliencies that were excessively high for the bank. Notwithstanding, more inconspicuous Bank Management's disappointments can be perceived in wasteful activities, poor interior climate control, and absence of management consideration at miniature level. It has been an intense test for the Indian Banks to viably form their development procedures lined up with the new monetary market. The current positive loan cost climate set up by the most recent RBI policies may appear to help the Indian Banks, anyway the effect of these policies on banks‟ clients and different businesses is indeterminable and consequently the Indian banks are confronted with a test to develop and productively deal with their loan cost spread to create a value while return for their investors. Likewise the management of the resource arrangement of different driving Indian Banks represents a huge test in the present monetary climate. Loans are a bank's essential resource class and when the presentation of these resources becomes far-fetched, at that point it indicates an emergency signs to the bank. Accordingly there is a requirement for the Indian Banks to see risk management as a progressing and esteemed action not exclusively to guarantee feasible development for the bank yet additionally to guarantee financial framework soundness of the country.

5. PRACTICES FOR RISK MANAGEMENT BY THE INDIAN BANKS:

A. Credit Risk Management

- **Exposure Limits**

The Reserve Bank of India has given a system of the principles/guidelines/directions for the Scheduled Commercial Banks identifying with credit exposure limits for single/bunch borrowers and credit exposure limits in explicit ventures and credit exposure of banks in the capital market.

- **Loan Review Process**

Banks have set up staggered loan audit cycle and constitution astute appointment of power. Predominant designated powers and special time plan for loan audit/recharging are offered over to the better-evaluated clients. Edge for new openings and periodicity for reestablishment are figured. Banks utilized „Credit Audit‟ that covered survey of authorization interaction, consistence and risk rating. It likewise tapped the admonition flags and suggested remedial activity with the target of improving credit quality.

- **Inside Risk Rating**

Most Indian banks have set up a serious risk rating framework that obviously characterizes their satisfactory rating limits and audits the evaluations occasionally, hence assisting with assessing the normal benefit/misfortune for the time frame.

- **Risk Based Pricing**

Banks are found to value the loans dependent on the risks apparent to be related with the borrower. High-risk classification borrowers are being estimated high when contrasted with the okay classification borrowers. Capital is distributed to retain the surprising misfortunes which are extended dependent on the recorded information on default misfortunes. Such banks are known to follow RAROC (Risk Adjusted Return on Capital) system.

- **Portfolio Management**

Indian banks have understood the significance of advancing the advantages got by expansion and the need of diminishing the expected unfavorable effect of convergence of openings to a specific gathering or industry. In this manner limits on total exposure to explicit high risk rating classifications, circulation of borrowers in different ventures and business bunch are kept up. The banks intermittently audit the loan portfolio and present changes as and when required.

B. Market Risk Management

- **Maturity Gap Analysis**

It is a risk management strategy which centers around the possible inconstancy of net-premium pay (NII) over explicit period spans, in this manner used to moderate loan fee risk. Bank plans that sort the resources, liabilities, and cockeyed sheet places that are exceptionally touchy to the loan fee vacillations, into time groups relying upon their development or time left for their next re-evaluating. These timetables create markers of both income and financial value concerning the loan cost affectability. The development gap mirrors the contrasts between the volume of rate touchy resource and the volume of rate delicate obligation. In this manner banks can extend the effect on their total compensation attributable to the changes in the loan cost.

- **Duration Gap Analysis**

Banks deal with their net revenue pay (NII) by representing all cash streams. Span is the weighted proportion of present estimations of all cash streams and shows the normal time needed to recuperate the venture. Term gap shows the distinctions in the circumstance of resource and risk cash streams. So when the loan fees rise, the market estimation of resources comparative with the market estimation of liabilities diminishes, bringing about fall of the market estimation of values and expected net-premium pay and the other way around.

- **Value at Risk (VaR)**

The Value at Risk (VaR) demonstrates the likely misfortune or gain the bank would make throughout a specific time skyline with a specific likelihood. Value at Risk fundamentally evaluates the financial risk innate in banks‟ portfolios into a numeric value. Risk Adjusted Rate of Return on Capital (RAROC) Framework RAROC system estimates every one of the significant risks reliably and helps banks‟ for making ideal risk/return compromise. This structure is utilized for dispensing capital for various items and organizations relying on the different risks that they face. This system decides the complete net profit from capital of a firm.

C. Operational Risk Management

- **Situation Analysis**

Situation investigation helps in recognizing expected issues via ground breaking and builds readiness to handle them. Results are conceived for various situations as are the ways that lead to them, along these lines giving banks a superior degree to ad lib likely arrangements. Outrageous situations are utilized for pressure testing of these likely arrangements.

- **Sensitivity Analysis**

Banks use affectability examination to discover the impact of progress in the estimation of a boundary on their tasks. Sensitivity investigation shows how much the information can be changed without huge change in the yield. Along these lines banks utilize this methodology for accomplishing operational effectiveness accordingly dealing with the operational risks.

- **Asset Liability Management**

In the Indian economy, for the most part the loan fees have been liberated; G-Secs are sold by RBI and the banks appreciate the freedom to choose the financing costs on stores and advances. Consequently the Asset Liability

Management work isn't just for risk management yet additionally utilized by the banks for upgrading their total assets through entrepreneurial situating of their accounting report. The higher the level of influence of the bank, the more basic is the Asset Liability Management work inside the association.

6. CONCLUSION

The current exploration focused on the risk management of the Indian banking plan. The examination respected the risk angles, for example market and credit risk. The examination respected the five public sector banks and five private sector banks. The exploration outlined objectives to look at Indian banking risk management utilizing optional and essential information. The exploration classified market risk into two segments, for example capital risk and interest rate risk. The examination created a push to contrast the risk and the Basel standard – III. The exploration result expressed that capital risk is discovered to be adequate for the public authority and private sector banks. Most banks oversee capital risk and keep monetary health in a safe region. The interest rate risk was assessed and the result demonstrated that most banks are susceptible to interest rate sensitivity as their liabilities cross the assets. Credit risk management has been explored with the financial ratios of picked public and private banks. The exploration additionally noticed that the vast majority of the working capital ratios of the public sector banks affect credit risk. The banks of the private business hold a slight position contrasted with the banks of the public sector. The examination respected the essential information of the staff who gives the clients the banking facilities. Through the plan issues, the examination assembled the information and carried out the factor analysis. The aftereffect of the examination expressed that the stressed staff won't play out the administrations effectively. Thorough administrative prerequisites of capital weight banking exercises. More often than not, new innovation won't fit into everyday operations. The banking framework partner ought to operate mutually to limit risk in market, credit, and operational risk viewpoints, so Indian banks stay serious with overall banks.

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