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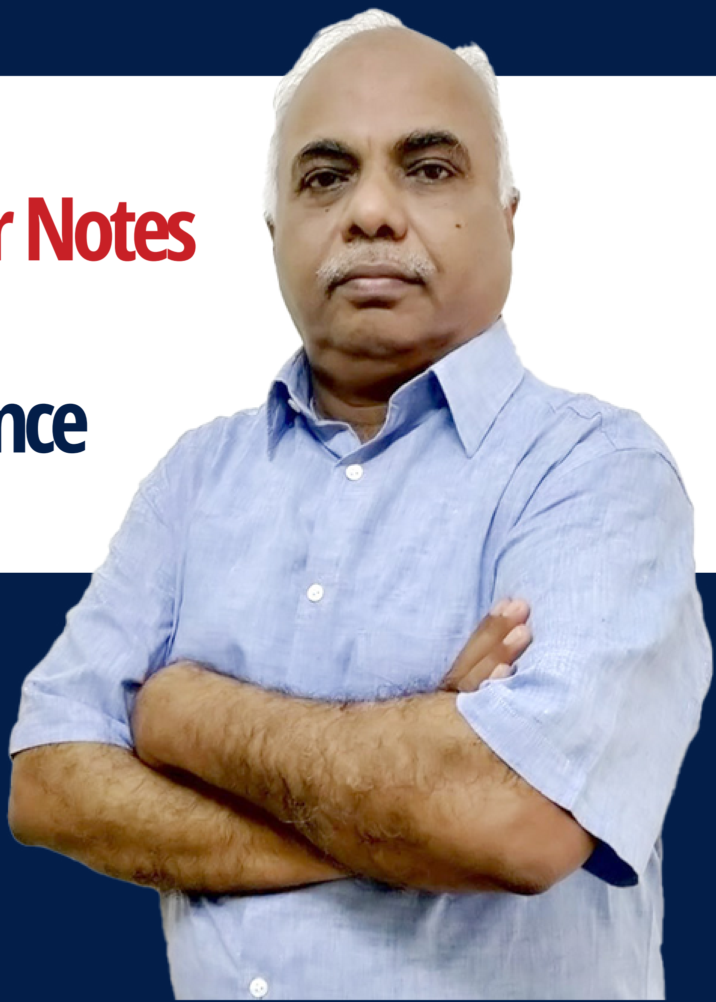
Risk & Basic Risk Management Framework



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Businesses now confront a variety of hazards in their day-to-day operations. A company's network, for example, may be hacked, exposing employee and customer information. Natural catastrophes like hurricanes, tornadoes, and wildfires may all have an influence on a company's capacity to function. It takes more than being able to react promptly to a danger to ensure the safety of a firm and its personnel. Effective risk management entails anticipating a threat before it occurs.

Types of Risks

The following is a list of the most essential forms of risk to consider while analysing investment possibilities for a financial analyst:

- Systematic Risk – The market's total influence.
- Unsystematic Risk — Uncertainty about a single asset or firm.
- Political/Regulatory Risk - The consequences of political actions and regulatory changes.
- Financial Risk - A company's capital structure (degree of financial leverage or debt burden)
- Changes in interest rates have an influence on interest rate risk.
- Uncertainties that are peculiar to a nation are referred to as country risk.
- Changes in social norms, movements, and discontent have an influence on social risk.
- Uncertainty regarding environmental obligations or the impact of environmental changes is one example of environmental risk.
- Uncertainty regarding a company's operations, such as its supply chain and the delivery of its products or services, is known as operational risk.
- Management Risk - The influence of a management team's choices on a corporation.
- Legal Risk - Uncertainty about litigation or operating freedom.
- Competition - The level of competition in a certain sector and the influence that rivals' decisions will have on a business.

What is Risk Identification?

The process of detecting and analysing hazards to an organization's operations and employees is known as risk identification. For example, identifying IT security risks such as malware and ransomware, accidents, natural catastrophes, and other potentially detrimental occurrences that might interrupt corporate operations are all examples of risk identification. Companies that have strong risk management plans are more likely to be able to mitigate the effect of risks when and if they materialise.

What are risk measures?

Risk measurements are statistical predictors of investment risk and volatility in the past, and they are also important components of current portfolio theory (MPT). MPT is a typical financial and academic tool for evaluating a company's or a stock fund's performance in relation to its benchmark index.

Risk measurement can be based on

1. Sensitivity
2. Volatility
3. Downside

Sensitivity – The deviation in the target variable is measured on the basis of variation on one variable component. It has a drawback as it considers variation in only one variable and not all variables at a time.

Volatility – It reflects instability or stability of any random variable. It is possible to combine sensitivity targets with variation in underlying parameters. It captures upside and downside deviations.

Downside potential – It is an adverse deviation target. It captures the possible loss & ignores the possible profit. The Value at Risk (VAR) is the downside risk measure.

What is Risk Mitigation?

Risk mitigation is a technique for preparing for and reducing the impact of hazards to a company. Risk mitigation, like risk reduction, aims to lessen the negative consequences of risks and catastrophes on business continuity (BC). Cyberattacks, weather occurrences, and other sources of physical or virtual harm are examples of threats that might put a business at danger. Risk mitigation is one aspect of risk management, and how it is implemented varies each company.

Risk Mitigation Strategies

The following are the types of risk mitigation strategies.
Risk Avoidance - When the repercussions of an issue are regarded too severe to warrant the expense of resolving it, risk avoidance is applied. An organisation, for example, might choose not to engage in particular economic operations or practises in order to avoid being exposed to the harm they may offer. Risk avoidance is a common business strategy that can range from limiting investments to not constructing offices in potential war zones.

Risk Acceptance - Accepting a risk for a set amount of time allows you to focus your mitigation efforts on other hazards.

Risk Transfer - Risk transfer divides risk among various parties based on their ability to guard against or minimise the risk. A faulty product constructed utilising some third-party material is one example of this.

Risk monitoring - It is the process of keeping an eye on projects and their related risks for changes in their impact.

What is risk-based pricing?

Risk-based pricing happens when lenders charge varying interest rates or loan conditions to different customers depending on the likelihood that they would default on their loans.

This implies that lenders may charge you a higher interest rate if they consider you a higher-risk borrower, such as if you've recently filed bankruptcy, lost a job, or are several mortgage payments late. Lenders will normally provide a cheaper interest rate for the same exact loan if they see you as a lower risk, such as because you have a strong credit score and are employed.

Pricing includes the following:
1. Cost of Deploying funds
2. Operating Expenses
3. Loss Probabilities
4. Capital Charge

Risk Monitoring & Control

The process of maintaining track of recognised riks, monitoring residual risks, detecting new riks, assuring the execution of risk plans, and assessing their efficacy in decreasing risk is known as risk monitoring control. Risk monitoring and control keeps track of the risk indicators that come with putting contingency plans in place. Risk management and control is a continuous procedure that lasts the duration of the project. As the project progresses, new risks emerge, and previously predicted hazards vanish.

Successful risk monitoring and control systems give information that aids in making effective decisions prior to the occurrence of the risk. To assess the acceptability of the project's risk level on a regular basis, communication with all project stakeholders is required.

Risk monitoring is used to assess whether:

- Risk mitigation has gone off without a hitch.
- Are risk response activities as successful as they should be, or should additional responses be developed?
- The assumptions made during the project are still valid.
- With the analysis of trends, risk exposure has altered from its previous condition.

- There has been a risk trigger.
- Policies and procedures are followed correctly.
- Risks that were not previously identified have happened or emerged.

Risk control may involve choosing alternative strategies, implementing a contigency plan, taking corrective action, or replanning the project. The risk response owner should report periodically to the project manager and the risk team leader on the effectiveness of the plan, any unanticipated effects, and any mid-course correction needed to mitigate the risk.

Components of Assets and Liabilities in Bank's Balance Sheet and their Management

The sources and uses of funds are included in a bank's balance sheet, just as they are in any other company's. Liabilities and net worth are the bank's sources of cash, whilst assets are the bank's uses of funds to produce income.
The summarised form and its components are:

Sources of Funds	**Application of Funds**
Capital	Cash in Hand and Balance with RBI
Reserves	Balances with Banks and Money at Call and Short Notice
Deposits	Investments
Borrowings	Advance
Other Liabilities and provisions	Fixed Assets
	Other Assets
TOTAL	TOTAL

Components of liabilities

Capital
Capital is the ownership share in a bank that provides as a safety net for depositors and creditors in the event of a loss. It is seen as a long-term funding source. The Reserve Bank of India sets minimum capital requirements for both local and international banks.

Surplus and Reserve
Statutory reserves, capital reserves, share premium, income and other reserves, and the profit and loss account balance are all included in this category.

Deposits
Deposits are the primary source of cash for banks. Current deposits, overdue deposits, call deposits, and other types of deposits are all categorised as deposits payable on demand. The second group is savings bank deposits, followed by term deposits such as fixed deposits, short deposits, and recurring deposits, which are repayable

after a set period of time.

Borrowings
In India, borrowings/refinance are received from the Reserve Bank of India (RBI), various commercial banks, and other organisations and agencies such as IDBI, EXIM Bank of India, NABARD, and others.

Other Liabilities and Provisions: The bank's other liabilities are divided into three categories:

- Drafts, telegraphic transfers, travellers' cheques, postal transfers payable, payslips, bankers' cheques, and other miscellaneous things are all examples of payable bills.
- Inter-Office Adjustments: The net inter-office adjustments credit balance.
- Interest Accrued: Interest on deposits and borrowings that has accrued but is not yet payable.
- Other: All other liabilities, such as income tax provisions, tax deducted at source, interest tax, provisions, and so on.

Components of Assets

Reserve Bank of India (RBI) Cash and Balances
This account lists all of a bank's cash assets, and it is the most liquid account a bank may have. The following items make up the monetary assets:

- Cash in Hand: This asset category comprises cash on hand, such as foreign currency notes and cash balances in the bank's international branches.
- Balances with RBI: The cash account also includes the balances kept by each bank with RBI to fulfil statutory cash reserve requirements (CRR) as well as surplus funds parked with RBI over and above the CRR requirement to cover emergency funding needs.

Investments
Investments in various types of securities are an important asset item on a bank's balance sheet. Government securities, authorised securities, shares, debentures, and bonds, as well as joint subsidiary ventures and other investments, are examples.

Advances
Advances are the most important asset on a bank's balance sheet. These advances, which reflect credit granted by a bank to its customers, make up a significant portion of all banks' assets.
- Credits in cash Repayable-on-Demand Overdrafts and Loans Advances are items in this category that are repayable on demand, however they may have a set due date.
- Term loans are short-term loans. This category includes all bank-issued term loans. These advances have a due date as well, but they are not repayable on demand. In a nutshell, the majority of term loans are repaid through EMIs (Equated Monthly Instalments).
- Purchased and discounted bills This category comprises any reduced bills acquired from clients by banks, regardless of whether they are clean/documentary or domestic/foreign.
- Advances that are both secured and unsecured. Advances are categorised into the following categories based on the underlying security:
- Secured by Tangible Assets: All advances or portions of advances made inside or outside India are secured by tangible assets.
- Unsecured Advances: All advances that do not have any security and which do not appear in the above two categories will come under this category.

Fixed Assets: All fixed assets of a bank, e.g., immovable properties, premises, furniture and fixtures, hardware, motor vehicles are classified into fixed assets.

Other Assets: Other assets are the remainder of the items on the asset side of a bank's balance sheet. The following are the many assets that appear:

- Inter-office Adjustments: The debit balance of the net position or interoffice accounts, both domestically and internationally.
- Interest Accrued: This includes interest earned but not paid on investments and advances, as well as interest due but not collected.
- Tax Deducted at Source/Advance Tax Paid: This covers the amount of tax deducted at source on securities as well as advance tax paid to the extent that it is not set-off against related tax provisions.
- Stationery and Stamps: This category accounts for the stock of stationery on hand.
- Non-Banking Assets Acquired in Satisfaction of Claims. Items under this account include immovable properties/ tangible assets which are acquired by a bank in satisfaction of the bank’s claims on others.
- Others: Other items primarily include claims that are in the form of clearing items, unadjusted debit balances representing additions to assets and deductions from liabilities and advances provided to the employees of a bank.

Contingent Liabilities

Contingent Liabilities are a type of liability that can arise at any time. Contingent liabilities indicate a bank's responsibilities under letter of credit issuance, guarantees and acceptances on behalf of constituents, and invoices received by the bank on behalf of its clients. Other contingent liabilities include unrecognised bank debts, liability for partially paid-up investments, liability for outstanding forward exchange contracts, and other items such as cumulative dividend arrears, rediscounted bills, underwriting, commitments, estimated number of contracts remaining to be executed on capital account but not provided for, and so on.

Asset Liability Management (ALM)

Financial institutions employ asset and liability management (ALM) to reduce financial risks associated with asset and liability mismatches. ALM techniques combine risk management with financial planning, and they're frequently employed by businesses to address long-term risks that occur as a result of changing conditions.

Asset and liability management can encompass a variety of things, such as strategic asset allocation, risk reduction, and regulatory and capital framework adjustments. When assets and liabilities are correctly matched, financial institutions are left with a surplus that may be actively managed to optimise investment returns and profitability.

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