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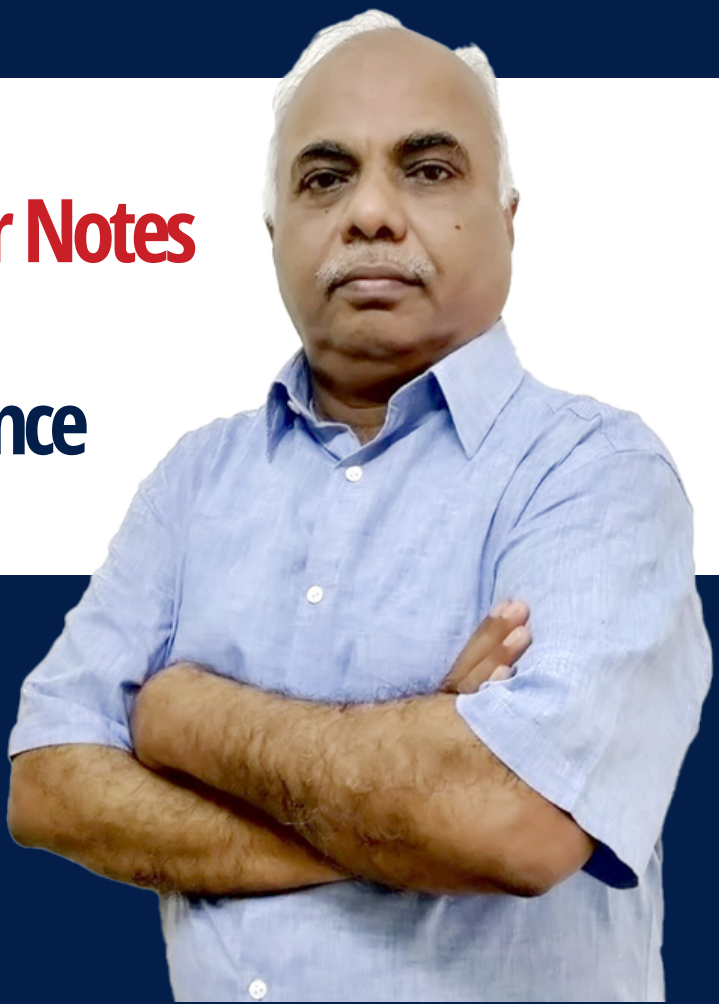
Risks in Banking Business For JAIIB Exam



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Risks in Banking Business

Aim

The aim of this study material is to:

a. Define the various types of risks that are prevalent in the banking and characteristics of such risks
b. Highlight the need for risk management and the process of risk management
c. Identify and discuss the main issues that are encountered in risk measurement and management process

Learning Objectives

After studying this material one should be able to:

a. Describe the various types of risks that are faced by banks
b. Highlight the need for risk management and tools to address them
c. Discuss the principles of risk measurement

Introduction

Banks are always faced with risk due to the nature of the business conducted by them. Banks or financial institutions not avoid risk tend to become stagnant over time and are unable to cater to the credit requirements of the society while banks that take excessive risk are most likely going to end up being overburdened. In this e-book, we will be discussing the six main types of risk that a bank is exposed to during its course of operations.

Before we move on with the types of risks associated with banking business. Let us first understand what risk is.

What is Risk?

Risk is defined as an unplanned event that has financial implications which result in loss for business or reduced earnings. It can also be defined as a condition in which the possibility of obtaining an undesirable outcome is high. We can say that risk is directly proportional to the return, therefore if a bank takes more risk, there is a good chance that it will earn higher returns.

Let’s look at the types of risks in banking business below:

Types of Risk

Most of the business risks arises due to the cause of mismatching of assets and liabilities. There are 7 major types of risk that are associated with the banking business and are enumerated as follows:

1. Credit Risk
2. Liquidity Risk
3. Interest Rate Risk
4. Market Risk
5. Country Risk
6. Solvency Risk
7. Operational Risk

Each of the risk types will be discussed in brief below:

Credit Risk

Credit risk is the most common of all the risks in banking business and also the one causing the most losses in terms of revenue. For example, if a small number of important customers of a bank default in their payments, it could lead to a large loss for the bank as a whole.

This risk is based on the possibility that loans may not get paid in time or some investments might degrade in quality over time or may get into default that causes loss to the bank.

Credit risk is not only limited to the risk from borrowers, it also includes payments not being processed on time and such delays can also cause loss to the bank.

The impact of degraded credit standing of such institutions lead to reaction from capital markets in form of higher interest rate on debt, declining share price and downgrading of its debt quality.

Due to this, bankers must exercise caution by maintaining a proper distribution of liquidity in assets and carry out evaluation of risk of defaulting of the borrowers.

The best way to protect oneself from credit risk is to maintain high standard of credit, accurate monitoring, having a good knowledge of the borrowers and proper collection procedures.

There are three main principles that are involved in credit risk management and they are:

- Selection
- Limitation

- Diversification

Selection means banks should carefully choose such persons or institutions whom to lend money. The credit application processing is done by credit officers or credit committees.

Limitations refers to the limits that are set by banks for processing maximum credit to individual or institutions.

Diversification refers to the spreading of credit to different types of borrowers, who belong to different sectors, geographical locations etc.

Liquidity Risk

Liquidity risk refers to the risk that arises due to the funding of long-term assets with short term liabilities. There is a requirement of liquidity for banks for these reasons:

a. It acts as a cushion to replace net outflows of the funds (funding risk).
b. To compensate for non-receipt of funds that are expected to be received as inflow (time risk)
c. To pay for contingent liabilities (call risk)
d. To undertake new transactions whenever required.

Liquidity risk is based on the premise that banks will be unable to fulfill one or more of the above-mentioned needs at a time.

Interest Rate Risk

Interest Rate Risk arises whenever the market value of equity or net interest margin of a financial institution is affected due to change in the interest rates.

The Interest Rate Risk can be viewed in two different ways such as

a. The impact of IRR on economic value of banks off balance sheet positions, liabilities and assets.
b. The impact of IRR on bank earnings.

Monetary environment or policies that are known to produce interest rate volatility in the market can result in instability of banking sector. Unexpected interest rate changes can cause banks and other financial institutions to fail. Therefore, banks need to understand and devise a proper way to manage interest rate risk exposure.

Market Risk

Market risk arises due to the sudden and fluctuating movement of the value of various trading portfolio or investments. Or it can arise when the investment is sold before attaining maturity. The different types of market risk are as follows:

Foreign exchange risk: It arises when the rate of currencies fluctuates in the market leading to possible loss to the bank, it is known as foreign exchange risk or forex risk.

Market Liquidity Risk: It arises when banks are unable to perform a large transaction in a particular instrument due to deteriorating market liquidity.

Country Risk

The country risk arises in banking business when the borrowers within a country are unable to fulfill their obligations. The country risk can be analysed on the basis of economic, social and political variables. There are two types of country risk which are: sovereign risk and transfer risk.

Sovereign risk: It refers to the risk of default by a sovereign government towards its foreign currency obligations.

Transfer risk: This states the condition when a government is unable to acquire foreign exchange in order to pay off the foreign debt obligations.

Solvency Risk

The solvency risk is another type of risk in banking business and it arises due to not having insufficient capital which can help to cover losses from all other risks generated in the business.

For addressing the solvency risk, the level of capital for all the kinds of risk should be defined properly.

Operational Risk

Operational risk arises in banking business due to deficiencies or shortcomings at a technical level in the bank such as information systems or at an organisational level like internal reporting of banks.

Such risks can also arise due to failure of banks to comply with the rules and regulations laid out for conducting operations.

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