GLOBUS PUBLICATION

Cosmos An International Journal of Management
A Refereed Research Journal
Vol 11 / No 2 / Jan-Jun 2022 ISSN: 2278-1218

A STUDY ON RISK MANAGEMENT PRACTICES IN INDIA

*Pratima
**Dr Arvind Kumar Tiwari

Paper Received: 06.06.2022 / **Paper Accepted**: 22.07.2022 / **Paper Published**: 25.07.2022
Corresponding Author: Pratima; doi:10.46360/cosmos.mgt.420221012

Abstract

Knowledge theorists claim that risk management is essentially the management of error, equivocality, risk, and uncertainty. Lack of information results in uncertainty, where the outcome cannot be calculated even at random. As information is gathered, this uncertainty changes into risk, where the outcome may be estimated. Risk management offers a way to reduce risk when market information and potential consequences become more apparent. Conflicting interpretations and the ensuing lack of judgement lead to ambiguity. Even with sufficient understanding of the circumstances, this still occurs. For this reason, banking and other institutions create incentive systems to handle agency issues in the risk-reward framework, control systems to reduce errors, information systems to reduce uncertainty, and cultural systems to deal with ambiguity.

Keywords: Risk Management, Uncertainty, Financial System, Economy.

Introduction

The financial system is the foundation of every economy since it directly affects a nation's economic growth and, consequently, the wealth and well-being of its citizens. The real economy is one of the other economic sectors that the financial system supports. For the economy as a whole to remain stable, the financial system must be stable. The main component of the financial system is the banking industry. The nation's banking industry and economy are closely related; each supports the other's expansion, sturdiness, and stature. Sustaining economic growth is predicated on a robust and robust financial sector.

The banking industry is essential to the growth of any given economy. It is the main force behind the nation's economic expansion and plays a vital role in converting idle capital resources for the best possible use in order to maximise productivity. In actuality, the health of the banking industry affects the base of a good economy and vice versa.

Although the banking industry in India is currently highly robust, it is nevertheless seen as a very dangerous venture. Risk-taking is necessary for financial institutions, but it must be done consciously. But keep in mind that banks are extremely brittle establishments that rely heavily on the confidence of their clients, their reputation as a brand, and-above all-dangerous leverage. If something goes wrong, banks can fail, and it only takes one bank to fail in order to cause ripple effects throughout the whole economy.

Literature Review

According to Nimesh (2018), The banking industry plays a crucial role in the economic governance of a country. The term "risk" can be described as a circumstance in which there is a possibility for an undesirable event to transpire, with the particular result being discernible and measurable, hence enabling the potential for insurance coverage. A risk can be described as an unanticipated event that gives rise to financial consequences leading to a reduction in profits. Risk management refers to the use of proactive measures in order to efficiently plan, lead, coordinate, and control the various hazards that are present in an organization's daily activities and long-term viability. Regardless of personal opinion, risk plays a substantial part in the achievement of objectives and the general prosperity of an institution. The objective of this article is to analyse the potential risks faced by the banking industry and examine the methodologies employed in risk management. This study also examined the diverse tactics utilised by the banking industry in the domain of risk management. To achieve the objectives of the study, data has been collected from secondary sources, including books, journals, and internet publications. The aforementioned sources have been applied to ascertain the multitude of dangers faced by financial institutions, develop an effective risk management approach, and evaluate various solutions implemented in the field of risk management. In conclusion, it is crucial for financial institutions to adopt a more prudent stance in relation to risk assumption, actively anticipate potential adverse changes, and employ suitable hedging tactics. Through the use of these practises, banks have the potential to strategically utilise them in order to attain a competitive advantage and optimise the overall operational effectiveness within the banking sector. Risk is commonly understood as any factor or circumstance that has the potential to impede or obstruct the successful attainment of

* *Research Scholar, Kalinga University, Naya Raipur, Chhattisgarh, India.*
** *Supervisor, Kalinga University, Naya Raipur, Chhattisgarh, India.*

specific goals or objectives. The presence of risk within a given circumstance can be attributed to either internal or external sources, contingent upon the specific type of risk involved. The potential for encountering such risk might exacerbate the severity of a given scenario. A more effective approach to addressing such a scenario involves implementing proactive steps to identify potential risks that may lead to unfavourable consequences. In more concise terms, it can be asserted that proactive risk management is more advantageous than reactive risk management. Risk management is a strategic approach employed to identify, analyse, and then address a specific risk. The aforementioned process is characterised by its continual nature and serves as a valuable instrument in the decision-making process. As stated by the Higher Education Funding Council for England (HEFCE), Risk Management encompasses not only the mitigation of unfavourable events but also the enhancement of favourable outcomes. According to the theoretical framework known as "Prospect Theory," individuals have a propensity to embrace risk rather than incur a certain loss. [1]

According to Renuka (2017) [2], The financial stability of the banking sector is undeniably crucial for the overall health and stability of any economy. The failure of large-scale banks not only has a profound impact on the home economy, but it also poses a significant risk to the global financial system. One notable illustration of this phenomenon is the financial collapse of Lehman Brothers in 2008. Within this context, it is imperative to examine the fiscal stability of domestic financial institutions. The implementation of the New Economic Policy in 1991 brought about substantial transformations in the Banking Industry of India. The banking industry has transitioned progressively from a regulated environment to a deregulated market economy. The banking sector is subject to various forms of risk. Risk is commonly described as any factor or circumstance that has the potential to impede or obstruct the achievement of specific goals or objectives. The current study examines the factors influencing the level of risk in the Indian banking industry, as well as the actions implemented by the Reserve Bank of India (RBI) to mitigate this risk. A comprehensive analysis of secondary data indicates that Indian commercial banks face a variety of risks, including but not limited to liquidity risk, interest risk, credit risk, interest rate risk, market risk, and operational risks. Various studies have employed diverse analytical methods to evaluate risk, including Altman's Z Score, GAP Analysis, Data Envelopment Analysis, Tobit-Regression Model, Back Propagation Neural Network, Black Scholes-Merton option valuation, ANOVA, CAMEL Model, and Sensitivity Analysis, among others. The assessment of the latest regulatory practises implemented by the Reserve Bank of India (RBI) to mitigate such risks has been conducted. The literature analysis indicates the necessity of conducting an empirical study to comprehensively examine the various elements that impact the banking industry. Furthermore, it is imperative that future research endeavours focus on the exploration of alternate methodologies for the development of risk management scores.

Analysis

Originally, risk control systems used by Indian banks followed Indian accounting standards and the regulatory framework. However, banks are subject to mark-to-market accounting due to the accelerating pace of deregulation and corresponding changes in consumer behaviour. As a result, Indian banks face a difficulty in creating a cohesive framework for assessing and managing risk that is both responsive to market events and consistent with company objectives. Given the dynamic nature of the market, banks must be vigilant regarding the convergence of national regulatory frameworks, modifications to international accounting standards, and, above all, shifts in their clients' business practises. Consequently, it is imperative that one adhere to the risk management guidelines that the RBI and BIS have recommended.

The CAMELS rating has been used by the Reserve Bank of India to assess the banks' financial stability. Capital Adequacy, Asset Quality, Management, Earnings Quality, Liquidity, and Sensitivity to Market Risk are the six components that make up the CAMELS Model.

The Basel Committee on Banking Supervision of the Bank for International Settlements (BIS) suggested in 1988 that a Financial Institution be evaluated based on its capital adequacy, asset quality, management quality, earnings, and liquidity (CAMEL). Sensitivity to market risk (S), the sixth component, was introduced to CAMEL in 1997. However, when evaluating the FIs' performance, the majority of developing nations use CAMEL rather than CAMELS. Some central banks-such as those in Kenya and Nepal-use CAEL rather than CAMELS. A popular technique for assessing the soundness of financial institutions is the CAMEL framework.

Up until the early 1990s, the RBI's statutory regulation of commercial banks in India was primarily concerned with licencing, the enforcement of minimum capital requirements, service pricing, including the setting of deposit interest rates, and requirements for credit, reserves, and liquid assets. Under these conditions, the oversight had to be primarily concerned with solvency problems.

Following the development of the BIS prudential standards in 1988, the RBI implemented a number of changes to its regulatory and supervisory standards in order to align them with global best practises. Simultaneously, it was careful to consider the nation's socioeconomic circumstances, business practises, widely used payment systems, and primarily agrarian economy. It also made sure that the prudential norms were gradually implemented throughout time and among various financial sector segments.

Ultimately, the RBI acknowledged the necessity for proper risk management in 1999 and gave banks rules for managing their assets, liabilities, credit, market, and operational risks. Under the guidance of a newly established Board for Financial Supervision (BFS), which operates under the RBI's auspices, the entire supervisory apparatus has been reorganised since 1994 to meet the rigorous requirements of a robust and stable financial system.

With the exception of capital market institutions and the insurance industry, the BFS currently has supervisory authority over the whole financial system. Off-site surveillance, which focuses specifically on the risk profile of the supervised institution, has been added to the Reserve Bank's targeted evaluations and periodic on-site inspections. Beginning in 1999, a system of grading banks based on CAMELS for Indian banks and CACS (Capital, Asset Quality, Compliance and Systems & Control) for foreign banks was implemented. Since then, the RBI has shifted its focus to stricter capital adequacy regulations and implemented the CAMEL-based rating system- which takes into account capital adequacy, asset quality, management, earnings, and liquidity-to assess the stability of Indian banks. The regulatory and supervisory purview of the Reserve Bank now include non-banking financial enterprises as well as financial institutions. Therefore, risk-based supervision (RBS) is the main focus given the changes in the banking sector. The primary supervisory concerns that the Board for Financial monitoring (BFS) addresses have to do with both on- and off-site bank monitoring.

Based on the "CAMEL" paradigm, banks have a yearly cycle for their on-site supervision system. It focuses on the fundamental evaluations required by the statute, such as solvency, liquidity, operational soundness, and prudent management. Thus, this is the basis for rating banks. Furthermore, given the current trends in financial globalisation, competition, and integration, the BFS must combine off-site surveillance with on-site supervision in order to detect "early warning signals" from off-site monitoring that could help prevent financial crises similar to the one that occurred in East Asia.

Capital sufficiency, asset quality, significant credit and concentration, linked lending, earnings, and risk exposures, such as currency, liquidity, and interest rate concerns, are all included in the off-site monitoring system. In addition, a further measure of the financial performance of banks will be provided by the technical and fundamental study of the banks' secondary market stock.

Thus, a risk profile for each bank will be created based on RBS. A high-risk, sensitive bank will be under closer supervision with shorter intervals and more supervisory instruments focused on structural meetings, extra off-site monitoring, frequent on-site inspections, etc. The Indian Financial System's stability will be guaranteed by taking this action.

Conclusion

As a result, bank management needs to be extremely careful in determining the kind and extent of the risk exposure it has and dealing with it accordingly. Furthermore, bankers need to view risk management as a valued, continuous endeavour, with the board serving as the model. A bank can expect to gain more money the more risk it takes because risk is closely correlated with return. More risk, meanwhile, also raises the possibility that the bank would suffer enormous losses and have to close. In actuality, a bank's activities nowadays must be managed with two objectives in mind: making a profit and remaining in operation. As a result, banks work to make sure that the risks they take are reasonable and well-informed. Therefore, the task of risk management is to maintain a trade-off between risk and reward. Also, a crucial problem associated with the stability of the financial system is risk management in the banking industry. Financial instability is frequently a result of poor risk management procedures guiding bank lending, as was particularly evident during the Asian financial crisis of 1997–1998.

One of the main pillars of banking initiatives to lessen the severity and mitigate risks posed by the financial sector is the broad reach and efficacy of risk culture. The ability to engage in high-level responsibility of the board of directors and top management on the banking sector, to establish a framework for risk appetite, and a thorough understanding of the occurrence and management of risk are among the factors that make an approach to risk culture acceptable and effective. The concept of risk culture is multifaceted and encompasses both attitudes and behaviours. Boards are concentrating on the bank's customs, attitudes, and actions around risk awareness, taking, and risk management as part of the risk culture process. One common theory on the causes of the global financial crisis is the misapplication of risk culture. The behaviour of bank employees and the management of the bank's external environment are significantly influenced by the risk culture of the bank. The 2008 global financial crisis and its aftermath exposed the shortcomings of certain banks and other financial organisations due to things like rogue trading and the misrepresentation of payment protection insurance. Prominent organisations like the Institute of International Finance (IIF) have even gone so far as to say that creating a "risk culture" within the company is probably the most important strategy for managing risks.

Conflict of Interest

There is no conflict of interest between the authors in this manuscript.

References

1. Jotaniya, Nimesh and Negi, Ruchi (2018). A Study on Risk Management in Indian Banking Sector. JETIR, 5(9), 255-261.
2. Kaur, G. & Sharma, Dr. Renuka (2017). Financial risk assessment and management by banks: Evidences from past research. International Journal of Applied Business and Economic Research, 15, 265-282.
3. Gabbi, G., & Levich, R. (2019). Controlling risks to ensure financial stability and reducing volatility. Journal of International Financial Management and Accounting, 30(3), 183-187. https://doi.org/10.1111/jifm.12107
4. Gupta, A., & Arya, P. K. (2019). Banking Reforms in India with Special Reference to Digital Banking. Asian Journal of Research in Banking and Finance, 9(7), 12. https://doi.org/10.5958/2249-7323.2019.00009.9
5. Hassan, M. K., Khan, A. & Paltrinieri, A. (2019). Liquidity risk, credit risk and stability in Islamic and conventional banks, Research in International Business and Finance, 48, 17-31. https://doi.org/10.1016/j.ribaf.2018.10.006
6. Hunjra, A. I., Mehmood, A., Nguyen, H. P. & Tayachi, T. (2020). Do firm-specific risks affect bank performance? International Journal of Emerging Markets.