Risk Management

Risk management is the process of identifying, assessing and controlling threats to an organization's capital and earnings. These threats, or risks, could stem from a wide variety of sources, including financial uncertainty, legal liabilities, strategic management errors, accidents and natural disasters.

Every business and organization faces the risk of unexpected, harmful events that can cost the company money or cause it to permanently close. Risk management allows organizations to attempt to prepare for the unexpected by minimizing risks and extra costs before they happen.

In the world of finance, risk management refers to the practice of identifying potential risks in advance, analyzing them and taking precautionary steps to reduce/curb the risk.

When an entity makes an investment decision, it exposes itself to a number of financial risks. The quantum of such risks depends on the type of financial instrument. These financial risks might be in the form of high inflation, volatility in capital markets, recession, bankruptcy, etc.

So, in order to minimize and control the exposure of investment to such risks, fund managers and investors practice risk management. Not giving due importance to risk management while making investment decisions might wreak havoc on investment in times of financial turmoil in an economy. Different levels of risk come attached with different categories of asset classes.

For example, a fixed deposit is considered a less risky investment. On the other hand, investment in equity is considered a risky venture. While practicing risk management, equity investors and fund managers tend to diversify their portfolio so as to minimize the exposure to risk.

Steps involved in a Risk Management Process

Identify the Risk

Analyze the risk

Evaluate or Rank the Risk

Treat the Risk

Monitor and Review the risk

Step 1: Identify the Risk

You and your team uncover, recognize and describe risks that might affect your project or its outcomes. There are a number of techniques you can use to find project risks. During this step you start to prepare your Project Risk Register.

Step 2: Analyze the risk

Once risks are identified you determine the likelihood and consequence of each risk. You develop an understanding of the nature of the risk and its potential to affect project goals and objectives. This information is also input to your Project Risk Register.

Step 3: Evaluate or Rank the Risk

You evaluate or rank the risk by determining the risk magnitude, which is the combination of likelihood and consequence. You make decisions about whether the risk is acceptable or whether it is serious enough to warrant treatment. These risk rankings are also added to your Project Risk Register.

Step 4: Treat the Risk

This is also referred to as Risk Response Planning. During this step you assess your highest ranked risks and set out a plan to treat or modify these risks to achieve acceptable risk levels. How can you minimize the probability of the negative risks as well as enhancing the opportunities? You create risk mitigation strategies, preventive plans and contingency plans in this step. And you add the risk treatment measures for the highest ranking or most serious risks to your Project Risk Register.

Step 5: Monitor and Review the risk

This is the step where you take your Project Risk Register and use it to monitor, track and review risks.

Risk is about uncertainty. If you put a framework around that uncertainty, then you effectively de-risk your project. And that means you can move much more confidently to achieve your project goals. By identifying and managing a comprehensive list of project risks, unpleasant surprises and barriers can be reduced and golden opportunities discovered. The risk management process also helps to resolve problems when they occur, because those problems have been envisaged, and plans to treat them have already been developed and agreed. You avoid impulsive reactions and going into “fire-fighting” mode to rectify problems that could have been anticipated. This makes for happier, less stressed project teams and stakeholders. The end result is that you minimize the impacts of project threats and capture the opportunities that occur.

Risk Management in Banking

In the course of their operations, banks are invariably faced with different types of risks that may have a potentially adverse effect on their business. Banks are obliged to establish a comprehensive and reliable risk management system, integrated in all business activities and providing for the bank risk profile to be always in line with the established risk propensity.

Risk management system comprises:

- Risk management strategy and policies, as well as procedures for risk identification and measurement, i.e. for risk assessment and risk management;

- Appropriate internal organization, i.e. bank's organizational structure;

- Effective and efficient risk management process covering all risks the bank is exposed to or may potentially be exposed to in its operations;

- Adequate internal controls system;

- Appropriate information system;

- Adequate process of internal capital adequacy assessment.

In their operations banks are particularly exposed to or may potentially be exposed to the following risks: liquidity risk, credit risk (including residual risk, dilution risk, settlement/ delivery risk, and counterparty risk); interest rate risk; foreign exchange risk and other market risks; concentration risk, particularly including risks of exposure of the bank to one person or a group of related persons; bank's investment risks; risks relating to the country of origin of the entity to which a bank is exposed (country risk); operational risk particularly including legal risk; risk of compliance of the bank's operations; risk of money laundering and terrorist financing; and strategic risk.

- **Liquidity risk** is the risk of potential occurrence of adverse effects on the bank's financial result and capital due to the bank's inability to meet the due liabilities caused by the withdrawal of the current sources of funding, that is, the inability to raise new funds (funding liquidity risk), aggravated conversion of property into liquid assets due to market disruption (market liquidity risk);

- **Credit risk** is the risk of potential occurrence of adverse effects on the bank's financial result and capital due to debtor's default to meet its obligations to the bank.

- **Residual risk** is the possibility of occurrence of adverse effects on the bank's financial result and capital due to the fact that credit risk mitigation techniques are less efficient than expected or their application does not have sufficient influence on the mitigation of risks to which the bank is exposed;

- **Dilution risk** is the possibility of occurrence of adverse effects on the bank's financial result and capital due to the reduced value of purchased receivables as a result of cash or non-cash liabilities of the former creditor to the borrower;

- **Settlement/Delivery risk** is the possibility of occurrence of adverse effects on the bank's financial result and capital arising from unsettled transactions or counterparty's failure to deliver in free delivery transactions on the due delivery date;

- **Counterparty credit risk** is the possibility of occurrence of adverse effects on the bank's financial result and capital arising from counterparty's failure to settle their liabilities in a transaction before final settlement of transaction cash flows, or, settlement of monetary liabilities in the transaction in question;

- **Market risks** entail foreign exchange risk, price risk on debt securities, price risk on equity securities, and commodity risk;

- **Interest rate risk** is the risk of possible occurrence of adverse effects on the bank's financial result and capital on account of banking book items caused by changes in interest rates;

- **Foreign exchange risk** is the risk of possible occurrence of adverse effects on the bank's financial result and capital on account of changes in foreign exchange rates;

- **Concentration risk** is the risk which arises directly or indirectly from the bank's exposure to the same or similar source of risk, or, same or similar type of risk;

- **Bank exposure risks** comprise risks of bank's exposure towards a single person or a group of related persons.

- **Bank's investment risks** comprise risks of its investments into non-financial sector entities and in fixed assets and investment property.

- **Country risk** is a risk relating to the country of origin of the person to which the bank is exposed, that is, the risk of negative effects on the bank's financial result and capital due to the bank's inability to collect receivables from such person for reasons arising from political, economic or social circumstances in such person's country of origin.

- **Operational risk** is the risk of possible adverse effects on the bank's financial result and capital caused by omissions (unintentional and intentional) in employees' work, inadequate internal procedures and processes, inadequate management of information and other systems, as well as by unforeseeable external events. Operational risk also includes legal risk.

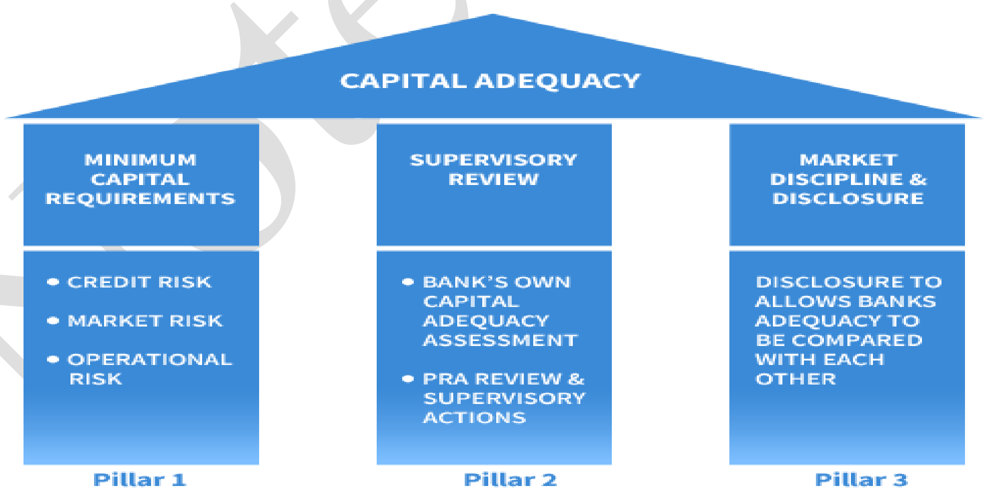
- **Legal risk** is the risk of loss caused by penalties and sanctions originating from court disputes due to breach of contractual and legal obligations, and penalties and sanctions pronounced by a regulatory body.

- **Risk of compliance of the bank's operations** is the possibility of occurrence of adverse effects on the bank's financial result and capital as a consequence of failure to comply its operations with the law and other regulations, standards of operations, anti-money laundering and counter-terrorist financing procedures, and other procedures as well as other acts governing the bank's operations, particularly encompassing the risk of sanctions by the regulatory authority, risk of financial losses and reputational risk.

- **Reputational risk** relates to the possibility of the occurrence of losses due to adverse effects on the bank's market positioning.

- **Strategic risk** is the possibility of occurrence of adverse effects on the bank's financial result and capital due to the absence of appropriate policies and strategies, their inadequate implementation, as well as changes in the environment where the bank operates or absence of appropriate response of a bank to those changes.

Basel-II



Basel II is a set of international banking regulations put forth by the Basel Committee on Bank Supervision, which leveled the international regulation field with uniform rules and guidelines. Basel II expanded rules for minimum capital requirements established under Basel I, the first international regulatory accord, and provided the framework for regulatory review, as well as set disclosure requirements for assessment of capital adequacy of banks. The main difference between Basel II and Basel I is that Basel II incorporates credit risk of assets held by financial institutions to determine regulatory capital ratios.

Basel II is a second international banking regulatory accord that is based on three main pillars: minimal capital requirements, regulatory supervision, and market discipline. Minimal capital requirements play the most important role in Basel II and obligate banks to maintain minimum capital ratios of regulatory capital over risk-weighted assets. Because banking regulations significantly varied among countries before the introduction of Basel accords, a unified framework of Basel I and, subsequently, Basel II helped countries alleviate anxiety over regulatory competitiveness and drastically different national capital requirements for banks.

Pillar 1: Capital Adequacy Requirements

Pillar 1 improves on the policies of Basel I by taking into consideration operational risks in addition to credit risks associated with risk-weighted assets (RWA). It requires banks to maintain a minimum capital adequacy requirement of 8% of its RWA. Basel II also provides banks with more informed approaches to calculate capital requirements based on credit risk, while taking into account each type of asset’s risk profile and specific characteristics.

An important part in Basel II is refining the definition of risk-weighted assets, which are used as a denominator in regulatory capital ratios, and are calculated by using the sum of assets that are multiplied by respective risk weights for each asset type. The riskier the asset, the higher its weight. The notion of risk-weighted assets is intended to punish banks for holding risky assets, which significantly increases risk-weighted assets and lowers regulatory capital ratios. The main innovation of Basel II in comparison to Basel I is that it takes into account the credit rating of assets in determining risk weights. The higher the credit rating, the lower the risk weight.

Pillar 2: Supervisory Review

Pillar 2 was added owing to the necessity of efficient supervision and lack thereof in Basel I, pertaining to the assessment of a bank’s internal capital adequacy. Under Pillar 2, banks are obligated to assess the internal capital adequacy for covering all risks they can potentially face in the course of their operations. The supervisor is responsible for ascertaining whether the bank uses appropriate assessment approaches and covers all risks associated.

Pillar 3: Market Discipline

Pillar 3 aims to ensure market discipline by making it mandatory to disclose relevant market information. The market discipline pillar provides various disclosure requirements for banks' risk exposures, risk assessment processes, and capital adequacy, which are helpful for users of financial statements to make informed trading decisions and ensure market discipline.