Risk Management in the next decade

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Looking at the current state of affairs in the banking system in India, a thought comes to mind – were some of the bankers in India as reckless as the real estate builders prior to introduction of RERA. Is RERA type regulation required to protect the depositor? Whoever understands risk better definitely manage it better. Amongst the various stakeholders – owner, regulator, banker, government, depositor, borrower and employees – the banker's interest in managing risk is utmost since, he is accountable to everyone else. The banker obviously has to understand risk better and manage it.

Risk management sits at the centre of banking and it is no coincidence that those firms which escaped the crisis relatively unscathed were those with a strong risk culture. Conversely, those banks that were bailed out by taxpayers either had inadequate risk management or neutered the function as it was regarded as an un-helpful brake on runaway growth, rather than an essential means of preserving shareholder value.

Before extrapolating on the risk management changes in the next decade, a review of the major risk events across the globe and in India is called for.

Major risk events impacting banking in India in the last decade

Global level

The 2008 International financial sub-prime crisis leading to Lehman brothers implosion, Bear Stearns collapse, Government capital and liquidity support for banks such as - RBS, Northern Rock, Fortis - fragile Italian banks, US Treasury rescue of Fannie Mae and Freddie Mac, Dodd Frank Act, Brexit, LIBOR market players conduct, recurring oil price fluctuations, Iran sanctions by the US government, New disrupting technologies, global ransomware attack that affected the computer systems of governments and several companies in various countries, including India.

India level

Basel 3 migration and implementation, Demonetisation, the Insolvency and Bankruptcy Code (IBC), GST introduction, Huge NPA build-up due to infrastructure lending, high level of credit, forex and operational related frauds witnessed, Malware related security breaches in banks card operations, external audit failures reflected by NPA divergences, corporate governance failures, PCA invocation in many banks by RBI, progressive integration of different markets – banking, capital, debt etc. - convergence of IT and telecommunication, emergence of new competitive players – Small Finance Banks, Payment Banks, Post Bank, NBFCs, credit card companies, mutual funds, growing digitisation of the economy and banking operations, hacking of Bangladesh bank's account with US Federal reserve with similar attempts in some banks in India, merger of SBI with its associates, merger of ING Vysya bank with Kotak Bank.

A look at the impact on SCBs balance sheets in the last three years

A review of some of the important risk ratios of scheduled commercial banks together with fraud data reveals the financial impact caused to the balance sheets of the banks as a result of the risk events.

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Risk ratios of SCBs over last three years.

Risk ratio	March 2016 (%)	March 2017 (%)	March 2018 (%)
CRAR	13.30	13.60	12.80
Tier-1	10.80	11.20	7.00
ROA	0.40	0.40	(-)0.20
ROE	3.60	4.20	(-)1.90
NIM	2.60	2.50	2.70
Gross NPA	7.50	9.30	11.60
Net NPA	4.40	5.30	6.10
No. of banks under PCA		2	9
Outstanding advances of PSBs	55,93,577	55,57,232	56,97,350
Outstanding advances of Private sector banks	19,39,339	22,19,475	26,62,753
Ratio of advances of private sector banks to PSBs	34.70%	39.90%	46.70%

Frauds in the Indian banking system (₹1 lacs and above) and NPA Write offs.

Year	No. of frauds	Frauds amount (₹ Crores)	NPA Write-offs (₹ Crores)
2012-13	4235	9870	7187
2013-14	4306	9483	13795
2014-15	4639	17025	50979
2015-16	4693	16603	59445
2016-17	5076	16788	82657
Total	22949	69769	214063

Efficacy and adequacy of existing risk management techniques

The deficiencies in adequacy and efficacy of existing risk management techniques in anticipating and managing various risks has been severely tested in the last decade at the national / international level as reflected by the emerging weakness both in banks and banking system. Capital has not proved to be a panacea for protection. There has been severe underestimation of different risks across the system. PCA under Pillar 2 by the regulator has come too late and aggravated the problem instead of preventing it. The rigidity of risk management structures across banks acting with a lag as a compliance tool has not helped either. The risk disclosures to stakeholders has been purely regulator driven without deriving the intended benefits.

The short-term approach of "run the bank" and long-term approach of "change the bank" do not need to be mutually exclusive. Banks can achieve the right balance between the two where one feeds the other.

Banking changes in next decade warranting risk management

A decade is, indeed, too long a period to predict in a fast moving world of changes (both magnitude and speed) across the economic and financial spectrum. Winners would be differentiated by their ability to exploit new digital opportunities, and to interface or compete with new digital players in areas where they have established a credible presence. Some of the anticipated changes could include the following:

- Acceleration of disintermediation through new financial instruments / structures / institutions with more global integration of markets and diverse products.
- Technological innovation driven by Fintech, block chain technology, bitcoin, artificial intelligence, virtual reality, e-wallet, P2P banking, e-commerce players.

- Re-drawing of the banking landscape under Basel III / IV etc. with profound impact on profitability forcing banks to merge and transform their business models.
- Wide, broad, deep and rigorous regulatory changes covering capital needs, money laundering, employment practices, environmental standards with attendant rising compliance costs, penalties and fines.
- Increasing complexities in money laundering and related management challenges.
- Key transformation - transition to International Financial Reporting Standard - IFRS accompanied by incremental MTM for banking book and dismantling of HTM.
- More systemically important banks with mergers of weak banks with stronger ones.
- Huge demands on banks in the areas of - management of liquidity, ALM mismatches, agriculture debt waivers and mandated lending.
- Increasing costs for deposit insurance, credit insurance, operational insurance.
- Stronger and complex consumer protection laws, higher consumer awareness and more litigation against banks.
- Chances of class action suits up in India particularly in FII held banks.
- Larger range of stakeholder target oriented intensive risk disclosures including credit rating of banks in public domain.
- Economic trade and currency wars spilling over to the financial system.
- Uberisation of banking – increasing transfer of risks and outsourcing.
- Customers will expect intuitive, seamless experiences, access to services at any time on any device, personalized propositions, and instant decisions.

Emerging risks

The top risks for the system and each bank have been changing on dynamic basis. Some of the risks which were hitherto absent would emerge. New risks are not limited to cyber. They can arise out of economic trends, geo-politics, clients and counterparties, markets and competitors, legislation and regulatory activity, internal processes and employees, and outsourcing. There will be faster rate of transition of risk shocks with higher frequency and larger impact to be managed.

- Leadership instability.
- Maintaining market share and profitability, managing competition.
- Accessing capital at optimal cost and managing market capitalisation.
- Rising operational risks – Process risk, information overflow, compliance & reputation plus entire range of Cyber risks - attacks, data security fraud, theft .
- HR risks- Monetising/retaining knowledge, conduct risk - own and outsourced employees, Sales/Market conduct, conflicts of interest, financial crime
- Economic & monetary shock absorption (contagion) and managing IFRS and tightening accounting and PCA norms .
- Unexpected high severity risk events threatening the very survival of the bank, such as data destruction and network disruption.
- Growing prominence of man-made risks vis-a-vis systemic risks.
- Risks linked to market volatility could materialize and vulnerabilities in the system will come to the test when markets get stressed.

What could be the major risk management challenges?

The risk management challenges to be battled will definitely vary with different countries based on economic and financial strength, level of market development, size & ownership of banking business, business lines and geographic spread as the pace of change accelerates as risk inter-connections deepen amidst proliferating signs of uncertainty, instability and fragility. Some major challenges identified are -

- With weak internal capital generation and low investor confidence impeding access to the equity capital market, finding capital to help clean-up balance sheets, meet Tier-1 Basel 3 needs, and fund growth.
- Quicker obsolescence of risk measurement systems requiring frequent risk model revisions, frequent software upgradation, superior back testing and simulation models.
- HR risks related to changes in human behaviour and motivating factors.
- Risks in bundling and cross-subsidising of products and services.
- Data security and IT related fraud prevention.
- Reputation risk management.
- Un-detected frauds – loans seasoned for years as NPA before detection as frauds.
- Change management – technology adaption, banking laws, business laws, business processes, organisational structures, alternate delivery channels.
- Managing shifting needs of consumers/ businesses, capturing the opportunities and managing the risks.
- Big data challenges (Volume, Velocity, Variety, and Veracity) using new (and now open source) tools and ideas.
- Transiting from painfully outdated IT legacy systems.

Risk management faces a period of large scale change. Under any of the scenarios that may play out in banking, risk functions will need to hone their abilities in many areas. They will need to be able to identify and address new risks quickly, be more agile and modular, deliver new technology and techniques rapidly, and work increasingly in partnership with finance, operations, and the businesses. These changes will require them to recruit, develop, and retain staff with skills that differ significantly from those that are found in risk functions today.

Countering the challenges

Risk management positioning would have to change by moving upfront from a reactive and response oriented to a pro-active function fine tuning risk in all business decisions by the decision makers with self-policing, self-sustaining risk management processes.

A fundamental change in approach towards risk is called for tracking opportunities and enabling business growth and profits. A few suggestions that can be explored -

- Having a Chief Strategy Officer to decide on new lines of business and acquisitions, product/ service innovations, HR management.
- Usage of predictive analytics, big data, machine learning, crowd sourcing fintech, block-chain technology, IOT, AI, robotics, larger process automation.
- Reduction of information asymmetry between borrower and lender to address credit risk ab initio.
- More forward looking ICAAP – internal capital adequacy assessment process.
- Enhancing range of services which can be outsourced to optimise benefits.
- To reduce risk collaborating more closely with

the business by integrating and automating the correct behaviour to eliminate human interventions.

- Investing in preventive software with real time online risk assessment, bank's positions and exposures, strengthening vigilance, monitoring and security control, both for in-house operations and external vendors.
- Development of better transfer pricing and cost centres, frequent revision of risk limits and re-appraisal of bank's risk appetite.
- Adoption of best practices from other industries with CEO and bank Directors from non-banking field e.g. airlines, pharmaceuticals, the military – how they continually seek to identify and manage new and critical risks.
- Role changing of risk management from a purely support function to a more business development and control function.

From a regulators standpoint, the challenge would be to keep the financial system stable on the one hand, while allowing the financial sector to innovate and grow, and serve the needs of the economy and society on the other. This would mean taking a proportionate approach to risk, so that banks can achieve resilience with efficiency, stability with growth, safety with innovation.

To conclude, have you wondered why is it that when an airline in India suffers huge losses, it finds it difficult to pay salaries (may be from depositor's money), while banks in same position don't worry at all and continue to pay income tax without actual cash inflows on accrued income. Are accounting practices on accrual basis and the fact that bank's business is enmeshed with money business responsible?

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