# CIBA
CERTIFICATE IN BANKING

## Session 3- Risk management

# Learning objectives

In this session you will learn:

- To identify the main risks faced by the bank
- How banks can mitigate such risks
- What is money laundering
- What is the BASEL accord

# DO THESE NEWSPAPER ARTICLES LOOK FAMILIAR?

# WHAT IS RISK?

- Risk= Results Not = Expectations
- Risk is Probability of LOSS due to
    - Non-happening of an expected event
    - Happening of an Un-expected event

Why should we take risk? Can there by any activity without Risk?

# WHAT ARE THE MAIN TYPES OF RISKS FACED BY BANKS?

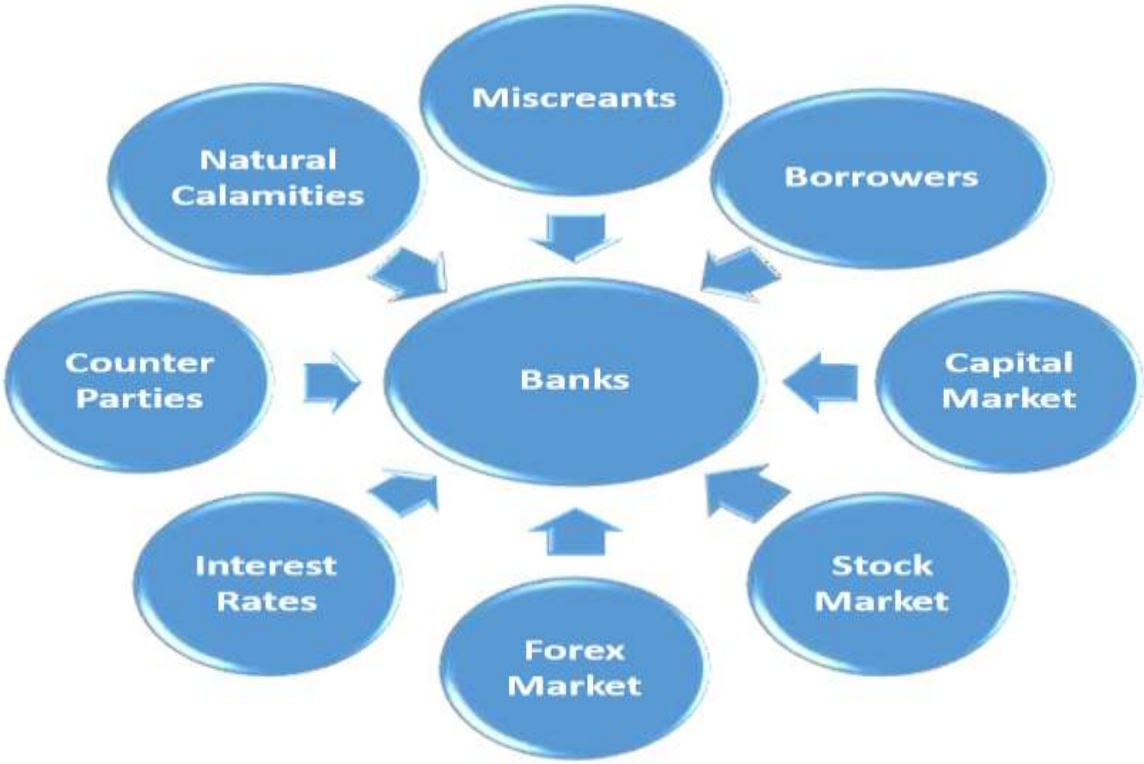
- Market Risk
- Credit Risk
- Operational Risk

# DRIVERS OF RISK

- Market Risk- External forces
- Credit Risk- Borrowers
- Operational risk- Internal processes

# INTERNAL FACTORS- RISK DRIVERS

# EXTERNAL FACTORS-RISK DRIVERS



# MARKET RISK

- It is the risk of loss from adverse movements in the level or volatility of interest rates, Exchange Rates and market prices of assets/ Commodities.
- The Bank may experience losses due to factors that affect the overall performance of investments in the financial markets.

# CREDIT RISK

It is the risk of loss from default by the Borrowers for repayment of principal as well as interest.

# Operational Risk

It is the unexpected Loss arising on account of deficiencies in information systems or internal controls. Operational Risk is inherent in any financial activity.

# WHAT IS RISK MANAGEMENT?

- ✓ Identify Risks
- ✓ Measure impact of Risk
- ✓ Establish Risk Hedging measures
- ✓ Overcome Risks before it comes over you
- ✓ Risk is inherent & co- extensive with activity

# OPERATIONAL RISK EVENTS

- Internal fraud.
- External fraud.
- Employment practices and workplace safety.
- Damage to physical assets.
- Business disruption and system failures.
- Execution, delivery and process management.

# MITIGATION OF OPERATIONAL RISK

- Define an operational risk policy at the Board level.
- Develop a system of effective internal controls with control activities defined at every business
  level.
- Have a well documented compliance policy
- Internal audit
- Employee training and motivation
- Stringent controls for new areas of activity including new products
- Disaster Recovery and Business continuity Plans
- Insurance and security measures
- Investment in Technology
- Outsourcing activities based on robust contracts and service level agreements

# WHAT IS MONEY LAUNDERING?

- Money laundering refers to any procedure to change the identity of illegally obtained money so that they appear to have originated from a legitimate source.
- Stages of money laundering
  - Placement
  - Layering
  - Integration

# AML GUIDELINES

- Prevention of Money Laundering Act passed in 2002 to prevent laundering. Came into effect from July 01, 2005
- It imposes obligation on banking companies, financial institutions and intermediaries to verify identity of clients, maintain records and furnish information in prescribed formto Financial Intelligence Unit (FIU-IND)
- RBI has provided detailed guidelines on the obligations of banks regarding KYC/AML/CFT
  - Every Bank is required to appoint a senior management officer as a Principal officer, who will report directly to senior management/ Board of Directors. He will be the liaison with the central Bank and other regulatory bodies for AML/CFT implementation. He will also be responsible for ensuring the guidelines within the Bank.
  - Every banking shall maintain a record of all cash transactions of the value of more than rupees ten lakhs or its equivalent in foreign currency
  - CTR and STR to be filed monthly with the FIU-IND

# CREDIT RISK

Risk of loss from default by the borrowers for repayment of principal as well as interest. Credit Risk may take other forms also:

- In the case of Guarantees or Letters of credit: Funds not forthcoming from the constituents upon crystallization of the liability
- In the case of Treasury Operations: Payment or series of payments due from the counter parties under the respective contracts not forthcoming or ceases
- In the case of Securities Trading businesses: Funds/ Securities settlement not getting effected due to insufficient funds or securities
- In the case of Cross-border exposure: Non availability and issues in free transfer of foreign currency funds or restrictions imposed by the sovereign.

# WHAT CAUSES CREDIT RISK?

- Macroeconomic factors:
  - Slowdown in the economy
  - Government policies- monetary, fiscal, licensing

- Company specific:
  - Aggressive lending policy
  - Absence of proper credit management policy
  - Inefficient management,
  - Fraudulent practices

# MITIGATION OF CREDIT RISK

- **Define a credit risk policy and strategy**
- **Adhere and review the 5C's of credit** –This is a system used by lenders to gauge the creditworthiness of potential borrowers.
  - **Character**—reflected by the applicant's credit history.
  - **Capacity-** measures the borrower's ability to repay a loan by comparing income against recurring debts and assessing the borrower's debt to income ratio
  - **Capital-** indicates the borrower's level of commitment / seriousness.
  - **Collateral-** This is the asset which is mortgaged for securing the loan.
  - **Conditions-** These are the terms and conditions of the loan.

# MITIGATION OF CREDIT RISK (contd.)

- **Portfolio monitoring**
  - Ensuring compliance with the terms and conditions of the loan.
  - Physically inspecting the factory, godown and the financial statements
  - Monitoring performance to check the continued viability of operations.
  - Verifying end use of credit.

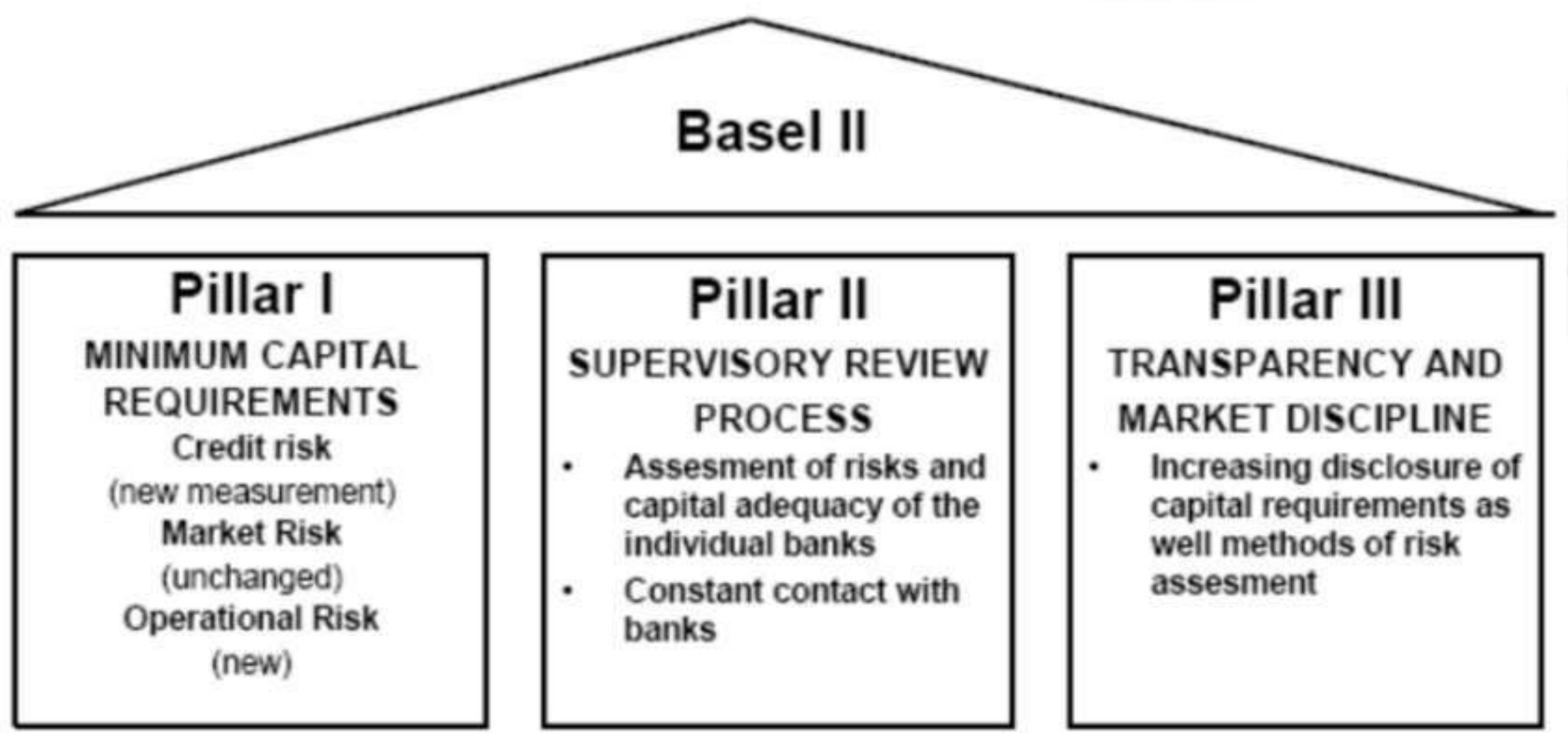
# BASEL-AN INTRODUCTION

- Basel Committee on Banking Supervision (BCBS) was formed in 1974 by central bankers from the G10 countries to develop global regulatory standards for banks and to strengthen micro and macroprudential supervision.
- It is one of the committees of the Bank for International Settlements (BIS), based in Basel, Switzerland.
- Presently 45 members.
- Committee's proposals do not have any legal force but are the accepted international standards of best practices in banking supervision.
- IMF and World Bank use the Basel's standards as a benchmark in conducting their assessment of the banking system of a country.

# BASEL ACCORDS

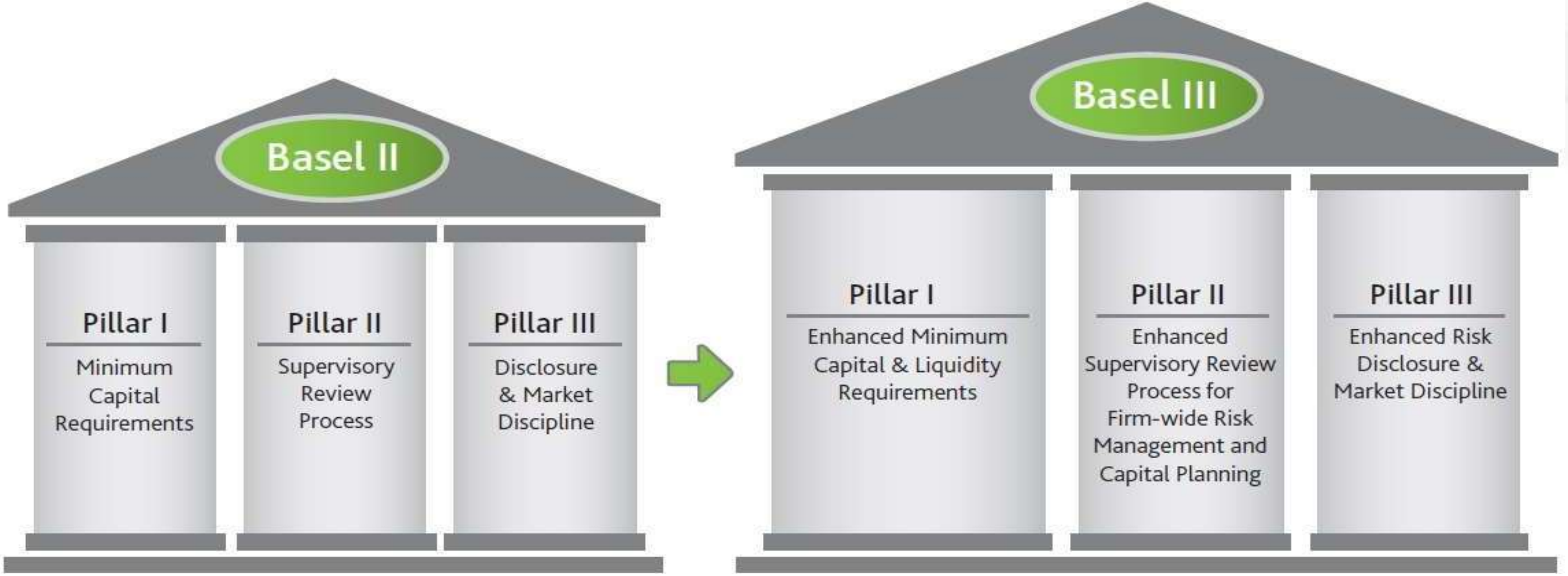
- **Basel 1** – introduced in 1988 and focused on the capital adequacy of financial institutions.
- Under Basel I, banks that operate internationally must maintain capital equal to at least 8% of their risk-weighted assets. This ensures banks hold a certain amount of capital to meet obligations.
- **Basel II -**introduced in June 2004

# 3 PILLARS OF BASEL II



# BASEL II TO BASEL III

- Basel III was introduced in Nov 2010 after reviewing the reasons for the collapse Lehman Brothers and other big financial institutions in 2008.



# Capital requirement under Basel II and III

## Introduction to Basel III

- Major features of Basel III are
  - Recommends to keep better liquidity (norms expected by 2015 end)
  - Counter cyclical buffer – to be used when stressed / bad times (hence 0%) and keep when healthy (3%)
  - Systematically Important Financial Institution (SIFI) expected to go beyond Basel III recommendation
  - Snapshot of Basel II vs Basel III comparison

| Requirements | Under Basel II | Under Basel III |
|---|---|---|
| Capital Conservation Buffers to RWAs | None | 2.50% |
| Minimum Ratio of Total Capital To RWAs | 8% | 10.50% |
| Minimum Ratio of Common Equity to RWAs | 2% | 4.50% |
| Tier I capital to RWAs | 4% | 6.00% |
| Leverage Ratio | None | 3.00% |
| Leverage Ratio for 8 SIFIs in US | None | 8.00% |
| Countercyclical Buffer | None | 0% to 2.50% |
| Minimum Liquidity Coverage Ratio | None | TBD (2015) |
| Net Stable Funding Ratio (NSFR) | None | TBD |

# Thank You