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RISKS IN THE BANKING SECTOR

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ABSTRACT :

The Project Safe and Secure Internet Banking System provides comprehensive electronic fund transfer and payment solutions that enable thousands of Citizens, Financial Institutions and hundreds of businesses the convenience of receiving and transferring their funds online.This will be accessible to all customers who have a valid User Id and Password. This is an approach to provide an opportunity to the customers to have some important transactions to be done from where they are at present without moving to bank. In this project we are going to deal the existing facts in the bank i.e.; the transactions which takes place between customer and bank. We provide a real time environment for the existing system in the bank. We deal in the method transaction in the bank can be made faster and easier that is our project is an internet based computerized approach towards banking.

INTORDUCTION :-

The Banking sector has a pivotal role in the development of an economy. It is the key driver of economic growth of the country and has a dynamic role to play in converting the idle capital resources for their optimum utilization so as to attain maximum productivity (Sharma, 2003). In fact, the foundation of a sound economy depends on how sound the Banking sector is and vice versa.

In India, the banking sector is considerably strong at present but at the same time, banking is considered to be a very risky business. Financial institutions must take risk, but they must do so consciously (Carey, 2001). However, it should be borne in mind that banks are very fragile institutions which are built on customers' trust, brand reputation and above all dangerous leverage. In case something goes wrong, banks can collapse and failure of one bank is sufficient to send shock waves right through the economy (Rajadhyaksha, 2004). Therefore, bank management must take utmost care in identifying the type as well as the degree of its risk exposure and tackle those effectively.

As risk is directly proportionate to return, the more risk a bank takes, it can expect to make more money. However, greater risk also increases the danger that the bank may incur huge losses and be forced out of business. In fact, today, a bank must run its operations with two goals in mind – to generate profit and to stay in business (Marrison, 2005). Banks, therefore, try to ensure that their risk taking is informed and prudent. Thus, maintaining a trade-off between risk and return is the business of risk management. Moreover, risk management in the banking sector is a key issue linked to financial system stability. Unsound risk management practices governing bank lending often plays a central role in 80 financial turmoil, most notably seen during the Asian financial crisis of 1997- 981

management and risk measurement, and identify commonly used techniques.

Definition of Risk :-
Risk refers to 'a condition where there is a possibility of undesirable occurrence of a particular result which is known or best quantifiable and therefore insurable' (Periasamy, 2008). Risk may mean that there is a possibility of loss or damage which, may or may not happen.

Risks may be defined as uncertainties resulting in adverse outcome, adverse in relation to planned objective or expectations - **Kumar, Chatterjee, Chandrasekhar & Patwardhan**

Risk may be defined as possibility of loss. It may be financial loss or loss to the reputation/ image - **Sharma**

Aims

• define the various categories of risk faced by banks and illustrate their main characteristics • demonstrate the need for appropriate risk management and risk measurement processes • introduce the key issues arising in risk

Learning objectives

After studying this chapter and having completed the essential reading and activities, you should be able to:

• describe and evaluate the variety and complexity of risks facing banks • illustrate and discuss the need for effective risk management tools and systems • explain the principles of risk measurement • explain how to evaluate the risk of a given position using the Value at Risk methodology

THE CONCEPT OF RISK

Risk can be defined as the "uncertainty regarding a loss." Losses, such as auto damage due to an accident or negligence regarding your property, can give rise to a liability risk. The loss involved with these risks is the lessening or disappearance of value.

Insurance companies have the right to deny insurance, or issue you a non-standard policy if they decide that your situation poses a risk too high for their definition of standard risk.

The law that requires an insurance company to reveal the source of any third-party information that caused it to deny or issue a nonstandard policy is known as The Fair Credit Reporting Act

There are two classes of risk :-

1. Speculative Risks involve the chance of either gain or loss.

For example, buying a lot for $4,500 and hoping to sell it for at least $6,000, is considered speculation and therefore, uninsurable. Buying into the market, at what is hoped to be low and selling high later, could result in gain and therefore, is uninsurable.

2. Pure risks involve, only the chance of loss.

For example, accidental injury, a fire in the garage and a debilitating illness have only the chance for loss and are therefore, insurable.

Why do we talk about managing banking risk?

It is the bank's business to take on and manage several kinds of risk for its clients. For the bank, all risks also have a cost that is related, among other things, to the need to make provisions for it - to be prepared for the financial impact should the risk come to pass. The bank is compensated for taking on this risk.

What are the typical risks for banking activities?

A "universal bank" like Society General, which combines retail banking activities with corporate and investment banking, manages various types of risks including:

- credit risk, meaning the risk of losses that result from the inability of the bank's clients or other stakeholders to meet their financial commitments;
- market risk, generated by trading activities (interest rates, foreign exchange, loss of value of financial instruments, etc.);
- operational risk, which refers to the risk of losses or sanctions due to procedural failures, human error or external events;
- liquidity risk, the risk that the bank cannot meet its cashflow obligations when they are due.

What is Society General risk policy?

In 2011, Society General launched an Enterprise Risk Management (ERM) programme with the goal of making its risk management systems simpler and more efficient. This is achieved by better integrating the concept of risk into the bank's strategy. Society General Society General has mapped all of its risks, defining a "risk appetite" for each of its businesses, as well as the operational thresholds that must not be

breached. But managing risks goes far beyond simple management systems. With a view to prevention, Society General also actively promotes a heightened "Risk Culture" in all of its teams, particularly through training and a programme of presentations, so that each employee is familiar with and able to manage the risks related to his or her activity.

Overview

Why Do the Risks for Banks Matter?

Due to the large size of some banks, overexposure to risk can cause bank failure and impact millions of people. By understanding the risks posed to banks, governments can set better regulations to encourage prudent management and decision-making. The ability of a bank to manage risk also affects investors' decisions. Even if a bank can generate large revenues, lack of risk management can lower profits due to losses on loans.

- The major risks faced by banks include credit, operational, market, and liquidity risk.
- Prudent risk management can help banks improve profits as they sustain fewer losses on loans and investments.
- Ways to decrease risks include diversifying assets, using prudent practices when underwriting, and improving operating systems.

Financial Risk

Financial risk is a term that can apply to businesses, government entities, the financial market as a whole, and the individual. This risk is the danger or possibility that shareholders, investors, or other financial stakeholders will lose money.

There are several specific risk factors that can be categorized as a financial risk. Any risk is a hazard that produces damaging or unwanted results. Some more common and distinct financial risks include credit risk, liquidity risk, and operational risk.

KEY TAKEAWAYS

- Financial risk generally relates to the odds of losing money.
- The financial risk most commonly referred to is the possibility that a company's cash flow will prove inadequate to meet its obligations.
- Financial risk can also apply to a government that defaults on its bonds.
- Credit risk, liquidity risk, asset-backed risk, foreign investment risk, equity risk, and currency risk are all common forms of financial risk.
- Investors can use a number of financial risk ratios to assess a company's prospects.

Financial risk mainly divided into two types .They are :-

1.credit risk

2.market risk

CREDIT RISK

Credit risk is the possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations. Traditionally, it refers to the risk that a lender may not receive the owed principal and interest, which results in an interruption of cash flows and increased costs for collection. Excess cash flows may be written to provide additional cover for credit risk

KEY TAKEAWAYS

- Credit risk is the possibility of losing a lender takes on due to the possibility of a borrower not paying back a loan.
- Consumer credit risk can be measured by the five Cs: credit history, capacity to repay, capital, the loan's conditions, and associated collateral.
- Consumers posing higher credit risks usually end up paying higher interest rates on loans.
- Credit risk is classified into 3 types .They are

1.Counter part risk/borrowers risk
2.Intrinsic risk/industry risk
3.Portfolio risk/Concentration risk

1.Counter part risk/borrowers risk

Counterparty risk is the likelihood or probability that one of those involved in a transaction might default on its contractual obligation. Counterparty risk can exist in credit, investment, and trading transactions

2.Intrinsic risk/industry risk

The intrinsic risk is the risk which is inherent in respect of an activity due to the operating environment. This is also termed as industry or activity risk.

3.Portfolio risk/Concentration risk

Portfolio risk is a chance that the combination of assets or units, within the investments that you own, fail to meet financial objectives. Each investment within a portfolio carries its own risk, with higher potential return typically meaning higher risk.

Portfolio risk is just one of the risks that traders should be wary of. Most risks apply to individual investments, but it is also important to ensure that your portfolio as a whole doesn't end up working against you.

Market risk

Market risk refers to the risk that an investment may face due to fluctuations in the market. The risk is that the investment's value will decrease. Also known as systematic risk, the term may also refer to a specific currency or commodity.
Market risk contrasts with specific risk, also known as business risk or unsystematic risk, which is tied directly with a market sector or the performance of a particular company. In other words, market risk refers to the overall economy or securities markets, while specific risk involves only a part.

KEY TAKEAWAYS

Market risk, or systematic risk, affects the performance of the entire market simultaneously.

Because it affects the whole market, it is difficult to hedge as diversification will not help.

Market risk may involve changes to interest rates, exchange rates, geopolitical events, or recessions.

NON- FINANCIAL RISK

NON-Financial Risk are Risk that arise from sources outside the financial markets such as actions within an entity. Environment ,community, suppliers and customer. These risk also have a monetary impact on the organization .

Why Do the Risks for Banks Matter?

Due to the large size of some banks, overexposure to risk can cause bank failure and impact millions of people. By understanding the risks posed to banks, governments can set better regulations to encourage prudent management and decision-making. The ability of a bank to manage risk also affects investors' decisions. Even if a bank can generate large revenues, lack of risk management can lower profits due to losses on loans. Value investors are more likely to invest in a bank that is able to provide profits and is not at an excessive risk of losing money.

Risk management system in banking

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;

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.

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CONCLUSION

The major risks faced by banks include credit, operational, market, and liquidity risk.

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.

Prudent risk management can help banks improve profits as they sustain fewer losses on loans and investments.

Ways to decrease risks include diversifying assets, using prudent practices when underwriting, and improving operating systems.