Lesson - 2

MANAGEMENT OF RISK IN FINANCIAL SERVICES - REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

2.0 Objective:

After studying this lesson, you shall be able:

* to understand the concept of Risk in Financial Services
* to know about various financial risks
* to discuss Risk Measurement and Risk Management under Basel Framework and
* to understand the Role of Regulators of Financial Services

Structure:

2.1 Risk in Financial Services:

2.2 Types of Risks

2.2.1 Interest Rate Risk

2.2.2 Credit Risk

2.2.3 Liquidity Risk

2.2.4 Operational Risks

2.2.4.1 Operational Risk : Types & Sources

2.3 Risk Measurement

2.4 Risk Management under Basel Framework

2.5 Improving Risk Management Systems

2.6 Role of RBI of Financial Services

2.7 Role of SEBI as Regulator

2.8 Strengthening of SEBI Powers

2.9 Powers of SEBI in regulating Financial Markets

2.10 Summary

2.11 Self Assessment Questions

2.12 Reference Books

2.1 Risk in Financial Services:

Risk is intrinsic to banking and financial services. Banks and financial institutions are

engaged in various financial services. They manage portfolios of assets and liabilities and the accompanying information flows. The key portfolio risks of banking are credit risk, interest rate risk and liquidity risk. These specific risks generate variability in bank's cash flows. Exessive risk taking and adverse economic conditions are the ingredients of bank failure. Risk management continues to be the corner stone of banking today and the ability to gauge risks and take appropriate action would be the key to success. The financial sector failures and banking sector weakness, have induced policy makers to devise prudent risk management mechanism. Market orientation of banking and rapid increase in the cross border movements of international capital have further increased the susceptability of the financial system of the world to a greater degree of risk.

2.2 Types of Risks:

As financial intermediaries, banks are confronted with various types of financial and non financial risks. These relate to interest rate, credit, liquidity, market, forex, equity price, legal, regulatory, reputational and operational risks. These risks are highly inter dependent and events that affect one area risk can have ramifications for a range of other risk categories. Banks therefore, are progressively becoming active to improve their ability to identify, measure, monitor and control the over all risk.

2.2.1 Interest Rate Risk: Interest rate risk management forms one of the most critical components of market risk management in banks. As opposed to a completely regulated regime earlier, almost complete deregulation of interest rates has exposed banks to adverse impact of volatility in interest rates. Generally, the net interest margin (NIM) of banks is a direct function of interest rate movements as such they have a bearing on the earning ability of assets and the costs of liabilities. The objective of interest rate risk management is to ensure a cash flow mechanism that is devoid of major mismatches in both assets and liabilities segments.

The primary form of interest rate risk arises from timing differences in the maturity (for fixed rate) and repricing (for floating rate) of assets, liabilities. The risk that the interest rate for different assets and liabilities may change in different magnitudes is called basis risk. Such risk arises due to imperfect correlation in the adjustment of the rates earned and paid on different instruments. When interest rates change, there differences can give rise to unexpected changes in the cash flows and earnings spread between assets and liabilities.

2.2.2 Credit Risk: Credit risk or default risk refers to the uncertainty associated with loan repayment. The most of the bank's earning assets being in the form of loans, and the problem with loan quality have been the major cause of bank failure. Symptoms of poor loan quality include high level of non performing loans.

2.2.3 Liquidity Risk: This refers to a type of risk which arises when adequate liquidity is not properly maintained by a bank to meet the demands of the public. Banks need liquidity for two reasons - to meet deposit withdrawals and to fund customers loan demand. Bank liquidity can be stored in the balance sheet by holding liquid assets such as treasury bills or short term instruments or through certificates of deposits.

2.2.4 Operational Risks: Operational risks may arise due to careless applied automation and integration of systems and by decreasing organisational ability to perceive, detect and comprehend fully the risk and its magnitude. Operational risk is not just internal and it can result from any component of the value chain. It is the risk of loss resulting from inadequate or failed internal processes, people and systems or external events.

Operational Risk: Types & Sources: Operational risk in a bank or financial institution would result due to following reasons.

* wrong/delayed decisions
* lack of accountability, control and proper auditing
* inadequate management information system (MIS)
* incompetency of staff and lack of proper training and job rotation.
* lack of succession planning and development of second line
* lack of contingency planning
* Non compliance with circulars, policies and regulatory requirements
* obsolete policies
* involvement of staff in frauds and forgeries
* failure of electronic instruments, like computers systems, software and telecommunication equipment
* legal flaws in execution of security documents for advances
* natural calamities and unanticipated changes
* deterioration of bank image due to poor services, staff behaviour and high NPAS etc;.

2.3 Risk Management:

For effective risk management, it is necessary to identify and quantity the risk. Various tools have been evolved to measure interest rate risk and hedge them so as to reduce their adverse impact on bank balance sheet. Risk measurement process involves assessment of the risk and evaluates it based on its criticality. Acceptance of core risks that are inherent to the business as a necessary part of being in business is an important preamble to managing risk. Risk management does not mean risk elimination and it comprises a host of activities like identification, prediction, measurement, mitigation or prevention and allocation of capital to cover operational risk.

Bank activities may be broadly divided into eight business lines, against each of which a broad indicator is specified to reflect the size or volume of bank's activities in that area. The business lines are: Corporate financing, Trading and Sales, Retail banking, Commercial banking, Payment and settlement, agency services and custody, asset management and Retail Brokerage. Banks have to appropriate manage these business lines profitably with proper checks and balances and with a structured management information system (MIS). There is a method called internal measurement approach (IMA) to measure the financial risk. Under this approach, a fixed and stable relationship is established between expected losses and unexpected losses. This relationship may be linear i.e.; the capital charge would be a simple multiple of expected losses or non-linear, i.e., the capital charge would be a more complex function of expected losses. Estimates of operational risk capital are based on measures of expected operational risk losses.

2.4 Risk Management under Basel Framework:

The history of the Basel International codes and standards of Bank for International Settlements (BIS) relating to minimum capital adequacy for banks goes back to the developed countries initiative in 1988 to protect the organisation for economic cooperation and development (OECD) banks from financial crisis during 1980s. According to the norm, the BIS reporting banks were to protect the depositors' money by raising capital form the market up to atleast 8 percent of the risk weighted bank assets. The assets consisting of advances and securities were attributed a three tier credit risk ranging from zero to 100 percent. Generally, government held debt (securities) carried a zero risk while bank borrowings and other loans were respectively at 20 percent and 100 percent.

In 1988, the BIS Committee of Banking regulation and supervisory practices established capital accord for international banks that became effective in 1993. The BIS capital standard called for an 8 percent capital to risk weighted assets and off balance sheet items consisting of two tiers of capital. Such a standard aimed at putting all banks on an equal footing with respect to capital adequacy so as to promote safety and soundness in banking. Basel - I played a significant role in strengthening the soundness and stability of the financial system. It proved the framework for fair and reasonable degree of consistency in the application of capital standards in different countries. Decade of nineties witnessed paradigm shift in supervisory and regulatory environment. Since then many changes have occurred in the structure and practices of banking and functioning of financial markets. Extensive recourse to financial innovations and growing complexity of financial transactions, however necessitated a revision of capital adequacy framework under Basel - I.

The above reasons have led to the evolution of Basel II capital accord. Following are the highlights of Basel II which were given a concrete shape in June 2004.

* It is based on three pillars i.e; minimum capital requirements, supervisory review and market discipline.
* For estimation of minimum capital requirements, credit, market and operational risks have been taken into consideration.
* A flexible approach has been adopted in assigning risk weight for strong and weak borrowers
* Two approaches namely, standardised approach and internal rating approach have been designed for measurement of credit risk.
* The Basel Committee has called for market transparency so that market participants can better understand banks risk profile and adequacy of their capital position.

Basel II and Containing Risk: Banks in India have been advised by RBI in March 2005 to adopt by March 2007, a new, proactive, approach towards risk management as laid down by the Basel Committee on Bank Supervision, an internationally recognised body of bank supervisors. Risk management has been basic to the banking business which is more leveraged than any other comparable business. Banks create a multiplier effect by lending more than what their level of deposits would normally permit. The more risks a bank takes on, the more it has to provide for by way of capital and reserves. Since 1988, banks in India and a hundred other countries have followed what is now referred to as the Basel I standard - a set of regulatory rules designed to cope with the

growing uncertaint in the global financial system. Better regulation and inculcating market discipline among banks have come to recognised as equally important. Basel II proposals would result in significant in crease in the capital change for banks in India.

2.5 Improving Risk Management Systems:

With the increasing degree of deregulation and exposure of banks to various types of risks, efficient risk management systems have become essential. The RBI has issued guidelines on asset liability management and risk management in banks. It should be seen as a medium whereby the risk management systems in India are constantly upgraded to address the changing environment. The current business environment demands a more integrated approach to risk management . The RBI has adopted the risk based approach to supervision since 2003 and about 23 banks were brought under the force of risk based supervision (RBS) on a pilot basis. On the basis of the feedback received from the pilot project, the RBS framework has been reviewed. The risk based approach to supervision is also serving as a catalyst to banks' migration to the integrated risk management systems. In view of the relevance of improved risk management systems under the changing circumstances and the larger emphasis placed on risk management systems in banks under Basel II, It is essential that the RBS stabilises at an early date and serves as important feedback not only to the bank managements but also to the RBI. The financial strength of individual banks which are major participants in the financial system, is the first line of defence against financial risks. Strong capital positions and balance sheets place banks in a better position to deal with and absorb the economic shocks. Banks need to supplement this with sophisticated and robust risk management practices and the resolve to face competition without diluting the operational standards. Banks have to develop technology based risk management tools to create structures for managing and mitigating risk.

Regulatory Framework for Financial Services:

All the banks and financial institutions which are engaged in different financial services were being regulated and monitored for proper growth and effective functioning. Ever since the SEBI Act (1982) was enacted, Merchant Bankers, Stock Brokers, Portfolio Managers, Registrars and Managers of mutual funds etc; are governed by the rules and regulations notified by the SEBI.

2.6 Role of RBI as Regulator of Financial Services:

The Reserve Bank is the apex organisation at the national level which is concerned with the efficient smooth functioning of the Indian financial system. The RBI keeps a watch on the developments and disturbances both of daily and seasonal nature in the financial system. It provides liquidity to the system with a view to facilitate the smooth functioning of the system. The flow of liquidity is controlled through money supply changes, reserve requirements of banks, open market purchases and sale of government securities etc;. The cost and availability of credit is also regulated by suitable monetary policy. The RBI can influence the operation in the financial system through not only the liquidity flows but also through regulation of the banking system of bank loans bank holdings of liquid assets, interest rates, public deposits with banks and non banking financial institutions.

The RBI Act says that the main function of the Bank is to regulate the issue of bank notes and keeping of reserves with a view of securing monetary stability in the country. Thus it is not only a banker to the government but also a banker to the commercial banks, cooperative banks and other

financial institutions in which capacity the RBI provides financial accommodation whenever they need. The Bank has also an important role to play statutorily on the maintenance of the external value of the rupee in view of the close inter dependence of international trade and national economic well being. The RBI has been entrusted with the custody of the country's international reserves and also represents the government at the IMF and operates exchange control and other restrictions on foreign payments and receipts.

As a regulator of the financial system, RBI would need a well developed and well organised financial system in which its actions could percolate from one segment to the other easily and quickly with the result that its control could become effective. RBI also controls and regulates the activities of commercial banks in terms of the Banking Regulation Act, 1949. These regulatory provisions were extended to cooperative banks in 1966 in terms of the Banking Laws (Cooperative Societies) Act 1965. In brief, it can be said that the Reserve bank has three types of functions in relation to the financial system - Financial, Regulatory and developmental.

The Reserve Bank and the financial services sector have gone through farreaching changes in the new millennium. Due to the deregulation measures initiated in the economy after Narasimham Committee (1991) recommendations, the decades of nineties has seen many changes in the financial system which are as follows:

* The Control and Regulatory aspects of RBI were curtailed
* Greater freedom and autonomy to banks with discretionary powers.
* Interest rate policy became more market oriented, less controlled and more flexible.
* The Money Market was reformed to have greater depth and width and number of players and instruments traded were both widened and strengthened.
* RBI became more autonomous and less dependent on the government for policy initiatives
* Financial markets have been kept open to foreign capital inflow and foreign expertise
* Rupee was allowed to freely fluctuate and current account controls were removed and some initiatives were taken towards less capital account controls.
* RBI was strengthened in its control on non banking companies and its regulatory role was extended to the whole financial system.

2.7 Role of SEBI as Regulator:

Securities Exchange Board of India setup in April 1988, became a legal entity in March 1992 and has since acquired larger and sweeping powers early in 1995. The SEBI has first started with issuing guidelines for merchant bankers, mutual funds, portfolio managers and then extended its regulations to all intermediaries in the market like brokers, sub brokers, under writers, registrars, custodians, collecting bankers, debenture trustees etc; SEBI has issued regulations for controlling Insider Trading, frauds and malpractices, for Takeovers and Acquisitions, Central Depositories and Practices of brokers in particular of all stock exchanges. SEBI also laid down a code of conduct to be followed by all registered intermediaries in the market.

Regulations of underwriters of capital issues ad capital adequacy norms for the stock brokers in the recognised stock exchanges were announced in October 1993. At the same time, the SEBI issued guidelines of disclosures in prospectus for investor protection. It has also issued guidelines for takeovers and substantial acquisitions to supplement the provisions of the listing agreement in this regard in the year 1994. It contains separate provisions for bail out takeovers and negotiated acquisition of shares. SEBI has the power to investigate any violations of these regulations. In March 1995, SEBI permitted listing of investment and finance companies, leasing and hire purchase companies on Over The Counter Exchange of India (OTCEI). Those were prohibited to be listed on the OTCEI.

Recent changes in New Issue Market:

In January 1996, the SEBI has dispensed with the requirement of a minimum promoters' contribution and lock in for listed companies with a three year dividend track record in the past five years. Since July 1995, the letters of offer for pure rights issue, unaccompanied by public issue are required to be filed with SEBI but no getting of the same is done by the SEBI and no acknowledgment card is necessary for rights issue. In January 1996, the SEBI has announced that it has stopped vetting all pure debt issues also, if unaccompanied by conversion facility into equity and if such issues are credit rated for adequate safety. The regulations for custodians were finalised by the SEBI in Jan. 1996 containing all the details about registration, annual fee, code of conduct, segregation of activities of each client, annual system of books of accounts, records etc; to be kept for inspection. The custodians would not be allowed to delegate work except to other registered custodians. Book building process was encouraged and initial public offer through book building has been picking up.

2.8 Strengthening of SEBI Powers:

The powers of the government under the securities contracts (Regulation) Act 1956 to control the stock exchanges and their members were delegated to the SEBI, with the final appellate power however resting with the Ministry of Finance. In 1995, the SEBI has been entrusted with more extensive penal powers and more extensive coverage of their jurisdiction. Options and futures which were earlier illegal are permitted to be introduced subject to the SEBI's approval. Even companies are brought under SEBI powers in respect of their capital market operations. Powers to grant recognition to stock exchanges, inspection and audit of stock exchanges and stock brokers' membership and other matters relating to stock exchanges including the recognition to new exchanges have been given to the SEBI.

Venture capital funds are brought under the control of SEBI and similar to guidelines given by SEBI for mutual funds, guidelines are also given for venture capital funds in Feb' 1996. Under the amendment to SEBI Act 1995, many more powers on controlling the intermediaries, investors and all players in the stock and capital markets including penal powers both civil and criminal are now vested in SEBI. In 2000, SEBI was declared by the government as the single controlling agency for the capital market. Nidhis, credit rating agencies. Money Market Mutual Funds (MMMFs) were all brought under the SEBI regulation during 2000.

2.9 Powers of SEBI in Regulating Financial Markets:

SEBI as a regulatory and development board has wide and varied powers to control and monitor the capital market for its smooth functioning. They are given below:

* Power to control stock exchanges
* Power to make and amend bye laws of recognised stock exchanges
* Power to grant registration to market intermediaries
* Power to prohibit insider trading
* Power to prohibit fraudulent and unfair trade practices relating to securities
* Power to promote investor's education end training of intermediaries in capital market.
* Power to levy fees
* Power to conduct research and market surveys
* Power to regulate depositories, custodian of securities, foreign institutional investors
* Company directors to be nominated by SEBI board making it more broad based
* Power to change regulations without prior got approval
* Powers to specify matters to be disclosed by listed companies etc;

Using the above mentioned powers to a great extent, SEBI has initiated several steps and measures to promote, develop and regulate the capital market in the country. These have taken place in the primary and secondary markets. SEBI has built its edifice on investor support and attracted public attention. SEBI has been attempting to professionalise the stock market by fixing up responsibilities and making the small investor a smart investor. Capital market scenario is certainly better than the past and it is poised for a healthy growth with speculative overdoses being kept under control with the sweeping powers being exercised by SEBI.

2.10 Summary:

The Indian financial sector has been well supported by suitable legislative measures taken by the government through various regulatory bodies like RBI, SEBI, IDBI and IRDA etc;. In order to improve efficiency in the banking and financial system, the RBI initiated a host of measures for the creation of healthy and competitive environment. The RBI has also taken sufficient measures to enhance the need for the usefulness of good corporate governance in the financial services sector. Money market is regulated by RBI through its monetary and credit policies keeping in view of the objectives of stable value of currency, promotion of economic growth and providing credit to the growing needs of different sector. Further, SEBI, another important regulator in the financial system, is playing a significant role in the development of securities market on healthy lines and in strengthening the institutions engaged in financial services. It is carefully monitoring the capital market by issuing various guidelines covering both primary and secondary markets from time to time in the changing business environment. Regulators have the most crucial role in improving the services of financial sector agencies in the country. It is significant to note that the road to efficiency lies in minimising regulatory prescriptions and maximising voluntary codes to ensure excellence in corporate governance. Their orderly conduct is an essential pre requisite for a healthy and strong economy.

2.11 Self-Assessment Questions:

1. What do you understand by Risk in Financial Services
2. What are various types of risks in Financial Services and its sources.
3. Examine in detail about Risk Management under Basel Framework.
4. Write briefly on Improving Risk Management Systems.
5. Describe the Role of RBI as Regulator of Financial Services.
6. Discuss the Role of SEBI as Regulator of Financial Markets.
7. Write short notes on:

   (i) Financial Risk
   (ii) Operational Risk
   (iii) Risk Measurement
   (iv) Role of SEBI in Capital Market.

2.12 Reference Books:

1. *Marketing of Financial Services* : V.A. Avadhani, Himalaya Publishing House, Mumbai, 2004

2. *The Indian Financial System* : Vasant Desai, Himalaya Publishing House, Mumbai, 1999.

- Dr. V.K. BHASKARA RAO