



Module-B Unit-1

CAIIB PAPER-2

BANK Financial Management(BFM)



CAIIB BFM Module B Unit 1: Risk and Basic Risk Management Framework

What Is Risk?

In most cases, we observe that there is deviation in what we achieve from what we had planned or what we had expected. This unpredictability of future is due to uncertainties associated with the steps that we undertake in the process or various external factors that influence the processes that are necessary to achieve our planned objective.

We may define 'Risks' as uncertainties resulting in adverse outcome, adverse in relation to planned objective or expectations. 'Financial Risks' are uncertainties resulting in adverse variation of profitability or outright losses.

Uncertainties associated with risk elements impact the net cash flow of any business or investment. Under the impact of uncertainties, variations in net cash flow take place. This could be favourable as well as unfavourable. The possible unfavourable impact is the 'RISK' of the business.

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- **Lower risk:** implies lower variability in net cash flow with lower upside and downside potential. Higher risk would imply higher upside and downside potential.
- **Zero Risk** would imply no variation in net cash flow. Return on zero risk investment would be low as compared to other opportunities available in the market.

Linkages Among Risk, Capital & Return

Linkage Between Risk & Capital:

Cash Flow from	Invest ment 1	Invest ment 2
1	6	3
2	6	9
3	6	5
4	6	-2
5	6	15
Total	30	30
Avg	6	6

- Higher the risk, higher the capital & vice- versa.
- Bank maintain capital funds as percentage of RWAs.
- Banks creating low risk assets can maintain low capital
- Bank exposing to high risk assets, have to maintain high capital
- If time value of money is not considered, both these investment yields Rs.30000 over a 5 year @ 12% pa.
- In this case Investment 1 is preferable bcz steady cash flow)
- If return is 10% and 12% on I1 & I2
- Investment 2 is preferred – 2% extra return but carries more risk as well.
- Hence RAROC = $12 - 2 = 10\%$

Basic Risk Management Framework

The basic considerations that should be taken into account for designing a risk management framework in an organisation are as follows:

1. Management of risk is a major concern for the top management. Successful implementation of risk management process emanates from the top management and the main challenge centres on facilitating the implementation of risk and business policies simultaneously in a consistent manner. Modern best practices consist of setting risk limits based on economic measures of risk while ensuring the best risk adjusted return keeping in view the capital that has been invested in the business. It is a question of taking a balanced view on risks and returns and that too within the constraints of available capital.

2. Management of risks begins with their identification and quantification. It is only after risks are identified and measured that we may decide to accept the

risks or to accept the risks at a reduced level by undertaking steps to mitigate the risks, either fully or partially. In addition, pricing of the transaction should be in accordance with the risk content of the transaction.

3. Risk management happens to be a job that requires special skills and has an objective which is more orientated towards the control aspect of the business, it requires a separate setup in the organization.

Response to these considerations calls for risk management framework in an organization that has well articulated processes covering the following areas:

- Organization for Risk Management
- Risk Identification
- Risk Measurement
- Risk Pricing
- Risk Monitoring and Control
- Risk Mitigation

Organisation for Risk Management

Usually, risk management organization consists of:

- The Board of Directors
- The Risk Management Committee of the Board
- The Committee of senior-level executives
- The Risk management support group

Risk Identification

Nearly all transactions undertaken would have one or more of the major risks, i.e., liquidity risk, interest rate risk, market risk, default or credit risk and operational risk with their manifestations in different dimensions. Although all these risks are contracted at the transaction level, certain risks such as risk and interest rate risk are managed at the aggregate or portfolio level. Risks such as credit risk, operational risk and market risk arising from individual transactions are taken cognizance of, at the transaction-level as well as at the portfolio-level.

Risk Measurement

Risk management relies on the quantitative measures of risk. The risk measures seek to capture variations in earnings, market value, losses due to default, etc., (referred to as target variables), arising out of uncertainties associated with various risk elements. Quantitative measures of risks can be classified into three categories

- Based on Sensitivity
- Based on Volatility

- Based on Downside Potential

Sensitivity: Sensitivity captures deviation of a target variable due to unit movement of a single market parameter. Only those market parameters, which drive the value of the target variable are relevant for the purpose.

Volatility: It is possible to combine sensitivity of target variables with the instability of the underlying parameters. The volatility characterises the stability or instability of any random variable. It is a common statistical measure of dispersion around the average of any random variable such as earnings, mark-to-market values, market value, losses due to default, etc.

Downside Potential: Risk materialises only when earnings deviate adversely. Volatility captures both upside and downside deviations. Downside potential only captures possible losses ignoring the profit potential. It is the adverse deviation of a target variable.

Risk Pricing

Risks in banking transactions impact banks in two ways. Firstly, banks have to maintain necessary capital, at least as per regulatory requirements. The capital required is not without costs. The cost of capital arises from the need to pay investors in bank's equity in the form dividends and for internal generation of capital necessary for business growth. Each banking transaction should be able to generate necessary surplus to meet this costs. The pricing of transaction must take into account the factors discussed in this para.

Pricing, therefore, should take into account the following:

- Cost of Deployable Funds
- Operating Expenses
- Loss Probabilities
- Capital Charge
- Profit Margin or Return on Network

Risk Monitoring and Control

The key driver in managing a business is seeking enhancement in risk-adjusted return on capital (RAROC). Therefore, the approach to risk management cannot be in isolation or in stand-alone mode. The approach to risk management centres on facilitating implementation of risk and business policies simultaneously in a consistent manner. Modern best practices consist of setting risk limits based on economic measures of risk while ensuring the best risk adjusted return, keeping in view the capital that has been invested in the business. It is a question of taking a balanced view on risks and returns and that too within the constraints of available capital.

In order to achieve the above objective, banks put in place the following:

- An organizational structure.
- Comprehensive risk measurement approach.
- Risk Management Policies adopted at the corporate level, which are consistent with the broader business strategies, capital strength, management expertise and risk appetite.
- Guidelines and other parameters used to govern risk taking including detailed structure of prudential limits, discretionary limits and risk-taking functions.

Risk Mitigation

Since risks arise from uncertainties associated with the risk elements, risk reduction is achieved by adopting strategies that eliminate or reduce the uncertainties associated with the risk elements. **This is called "Risk Mitigation".**

Enterprise-Wide Risk Management (EWRM)

- EWRM can be defined as a continuous and structured process of listing the objectives of the organisation;
- identifying all external and internal risk-factors that could impact the achievement of the objectives and organisation's business and financial targets; prioritising the risk-factors;
- Exploring alternatives for mitigating the risks; and controlling and monitoring such risks.
- Thus, EWRM encompasses the entire gamut of the organisation's operations and is not limited to a single event or circumstance impacting the organisation's functioning. It is a dynamic process involving people at all levels, covers every aspect of the organisation's resources and operations and takes a holistic picture of the entire organisation for the purpose of risk management.

The implementation of EWRM involves the following steps:

Evaluation of the existing risk management systems involving

- Review of the internal environment with a view to assess the risk philosophy and risk culture
- Review of the process of setting objectives
- Assessment of the existing mechanism of identifying risk-factors that can affect achievement of the desired objectives
- Evaluation of the existing process of assessing risks
- Assessment of the process of responding to identified risks
- Evaluation of the adequacy of existing control processes
- Assessment of the adequacy of existing management information system (MIS)
- Review of the process of monitoring risks

Formulation of a road map for the implementation plan that seeks to bridge the gaps in risk management practices vis-à-vis EWRM.

- Banks have identified and started adapting the Enterprise Risk Management Framework released by COSO (Committee of Sponsoring Organizations of the Treadway Commission) as a framework to drive their initiatives in risk management beyond Basel norms and regulatory compliances.
- The COSO ERM framework has all the components that could help the banks to stand a chance to derive business value while meeting compliance requirements.

The ERM Framework is structured around:

- Eight key components viz Internal Environment, Objective setting, Risk Assessment, Risk response, Control Activities, Information & Communication, Monitoring
- Four key objectives of business viz. strategic, operations, reporting and compliance.



Enterprise risk management (ERM) helps in identifying and selecting among alternative risk responses – risk avoidance, reduction, transfer, and acceptance. It helps to ensure effective reporting and compliance with laws and regulations, and avoid damage to the entity's reputation and associated consequences. As the risks keep constantly changing and evolving in a global economy, ERM is a never ending journey.

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