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Module-B Unit-2
CAIIB PAPER-2

BANK Financial Management(BFM)

CAIIB BFM Module B Unit 2: Risk in Banking Business

Risk Identification In Banking Business

Banking business lines are many and varied. Commercial banking, corporate finance, retail banking, trading and investment banking and various financial services form the main business lines of banks Within each line of business, there are sub-groups and each sub-group contains a variety of financial activities. Bank's clients may vary from retail consumer segment to mid-market corporate/large corporate financial institutions. Banking services may differ appreciably for each segment even for similar services.

	Business Lines of Banking Industry	
Business Lines	**Sub-groups**	**Activities**
Corporate Finance	Corporate Finance Municipal/Government Finance Merchant Banking Advisory Services	Mergers and acquisitions, underwriting privatisations, securitisation, research, debt (government, high yield), equity, syndications, IPO, secondary private placements
Trading and Sales	Sales Market making Proprietary Positions Treasury	Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage
Retail Banking	Retail Banking Private Banking Card Services	Retail Lending & Deposits, Banking Services, Trust and Estates Private Lending & Deposits, Banking Services, Trust and Estates, Investment Advice

		Merchant/Commercial Corporate Cards, Private Labels and Retail
Commercial Banking	Commercial Banking	Project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange
Payments and Settlement	External Clients	Payments and collections, funds transfer, clearing and settlement
Agency Services	Custody Corporate Agency Corporate Trust	Escrow, depository receipts, securities lending (customers), corporate actions Issuer and paying agents
Asset Management	Discretionary Fund Management Non-Discretionary Fund Management	Pooled, segregated, retail, institutional, closed, open, private equity Pooled, segregated, retail, institutional, closed, open
Retail brokerage	Retail Brokerage	Execution and full service

From the risk management point of view, banking business lines may be grouped broadly under the following major heads.

- The Banking Book
- The Trading Portfolio
- Off-Balance Sheet Exposures

The Banking Book

The banking book includes all advances, deposits and borrowings, which usually arise from commercial and retail banking operations. **All assets and liabilities in banking book have the following characteristics:**

- They are normally held until maturity.
- Accrual system of accounting is applied.
- They are not subjected to MTM (mark to market) exercise.

- They attract capital charge on credit risk and not on market risk.

The Trading Book

The trading book includes all the assets that are marketable, i.e., they can be traded in the market. Contrary to the characteristics of assets and liabilities held in the banking book, the trading book assets have the following characteristics:

- They are normally not held until maturity and positions are liquidated in the market after holding the assets for a certain period
- Mark-to-Market system is followed and the difference between the market price and the book value is taken to profit and loss account.

The trading book mostly comprises of fixed income securities, equities, foreign exchange holdings, commodities, etc., held by the bank on its own account.

Off-Balance Sheet Exposures

- **Off-balance sheet exposures are contingent in nature. Where banks issue guarantees, committed or backup credit lines, letters of credit, etc.,** banks face payment obligations contingent upon some event.
- These contingencies adversely affect the revenue generation of banks. Banks may also have contingent assets (for example, a bank may have purchased insurance to protect against certain negative events).
- Here banks are the beneficiaries subject to certain contingencies. Derivatives are off-balance sheet market exposures. They may be swaps, futures, forward contracts, foreign currency contracts, options, etc.

Banking Risks - Definitions

From the discussion above, we may summarise the major risks in banking business or "Banking Risks'. They are listed as follows:

- Liquidity Risk
- Interest Rate Risk
- Market Risk
- Default or Credit Risk
- Operational Risk

Liquidity Risk

The liquidity risk of banks arises mainly from funding of long-term assets by short-term liabilities, thereby making the liabilities subject to rollover or refinancing risk. Liquidity Risk is defined as the inability to obtain funds to meet cash flow obligations at a reasonable rate.

- **Funding Risk:** This arises from the need to replace net outflows due to unanticipated withdrawal non-renewal of deposits (wholesale and retail)/premature closure of term deposits;
- **Time Risk:** This arises from the need to compensate for non-receipt of expected inflows of funds i.e. performing assets turning into non-performing assets; or borrowers not repaying their instalments (EMI) on due dates; and
- **Call Risk**: This arises due to crystallization of contingent liabilities since customers are not meeting their commitments on due dates. This may also arise when a bank may not be able to undertake profitable business opportunities when it arises.

Interest Rate Risk

Interest Rate Risk (IRR) is the exposure of a Bank's revenue to adverse movements in interest rates. Interest Rate Risk (IRR) refers to potential adverse impact on Net Interest Income or Net Interest Margin or Market Value of Equity (MVE), caused by changes in market interest rates. It may be defined as the risk of changes in the financial value of assets or liabilities (or inflows/outflows) because of fluctuations in interest rates.

- **Gap or Mismatch Risk:** A gap of mismatch risk arises from holding assets and liabilities and off-balance sheet items with different principal amounts, maturity dates or repricing dates, thereby creating exposure to unexpected changes in the level of market interest rates.
- **Basis Risk:** The risk that the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude is termed as basis risk.
- An example of basis risk would be to say in a rising interest rate scenario asset interest rate may rise in different magnitude than the interest rate on corresponding liability creating variation in net interest income.
- **Yield Curve Risk:** In case the banks use two different instruments maturing at different time horizon for pricing their assets and liabilities, any non-parallel movements in yield curves would affect the NII.
- **Reinvestment Risk:** Uncertainty with regard to interest rate at which the future cash flows could be reinvested is called reinvestment risk. Any mismatches in cash flows would expose the banks to variations in NII as the market interest rates move in different directions.
- **Net Interest Position Risk:** Where banks have more earning assets than paying liabilities, interest rate risk arises when the market interest rates adjust downwards. Such banks will experience a reduction in NII as the market interest rate declines and increases when interest rate rises. Its impact is on the earnings of the bank or its impact on the economic value of the bank's assets, liabilities and OBS positions.

Market Risk

Market risk is the risk of adverse deviations of the mark-to-market value of the trading portfolio, due to market movements, during the period of holding. This results from adverse movements of the market prices of interest rate instruments, equities, commodities and currencies. Market Risk is also referred as Price Risk.

- **Forex Risk:** Forex risk, also termed as Exchange Risk, is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position, either spot or forward, or a combination of the two, in an individual foreign currency.
- **Marker Liquidity Risk:** Market liquidity risk arises when a bank is unable to conclude a large transaction in a particular instrument near the current market price.

Default or Credit Risk

Credit Risk is most simply defined as the potential of a bank borrower or counterparty fail to meet its obligations in accordance with agreed terms. For most banks, loans and corporate bonds are the largest and most obvious source of credit risk.

- **Counterparty Risk:** This is a variant of credit risk and is related to non-performance of the trading partners due to counterparty's refusal and or inability to perform. Normally such defaults happen in Call money borrowing between banks since it is purely unsecured. The counter-party risk is generally viewed as a transient financial risk associated with trading rather than standard credit risk.
- **Country Risk:** This is also a type of credit risk where non-performance by a borrower or counter-party arises due to constraints or restrictions imposed by a country. In this case, the reasons for non-performance are external factors on which the borrower or the counterparty has no control.

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Strategic risk and reputation risk, though in the nature of operational risk, are not covered under the definition of operational risk by BCBS.

- **Transaction Risk:** Transaction risk is the risk arising from fraud, both internal and external, failed business processes and the inability to maintain business continuity and manage information.
- **Compliance Risk:** Compliance risk is the risk of legal or regulatory sanction, financial loss or reputation loss that a bank may suffer as a result of its failure to comply with any or all of the applicable laws, regulations, codes of conduct and standards of good practice. It is also called integrity risk since a bank's

reputation is closely linked to its adherence to principles of integrity and fair dealing.

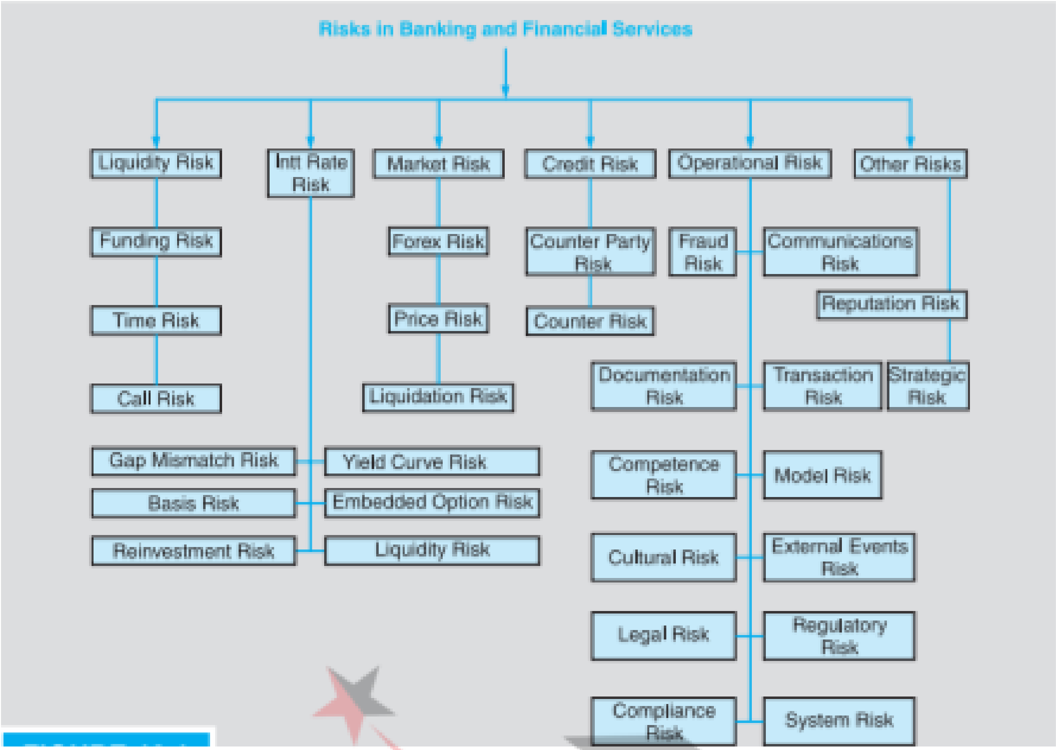
- **Strategic Risk:** Strategic Risk is the risk arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organisation's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals and the quality of implementation. In short, this risk calls for whether there is gap between the strategy aimed at and implemented. If there is a gap, then the strategy is not implemented in letter and spirit.
- **Reputation Risk:** Reputation Risk is the risk arising from negative public opinion. This risk may expose the institution to litigation, financial loss, or a decline in customer base. Risks faced by banking and financial services may be summarised as shown in

Model Risk

Models are designed to predict values of variables for which it is specifically designed. Value of a given variable would depend upon one or more parameters, which influence the value of the given variable.

Model risk usually arises because of the following reasons:

- Incorrect assumptions or assumptions, which have become non-relevant
- Ignoring one or more parameters – usually for simplification or for some practical reasons
- Errors of statistical techniques or insufficient data points
- Incorrect judgment in dealing with outliers, etc.



Climate Risk

Climate-related risks refer to the potential risks that may arise from climate change or from efforts to Mitigate climate change, their related impact, and the economic and financial consequences. It can Impact on the financial sector through two broad channels i.e., physical risks and transition risks.

- **Physical risks**, which arise from the changes in weather and climate that impact the economy. They can be categorized as acute risks (such as floods, heatwaves, landslides etc).
- **Transition risks**, which arise from the process of adjustment towards a low-carbon economy. This can have a significant impact on the economy.
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