CORE RISKS IN BANKING

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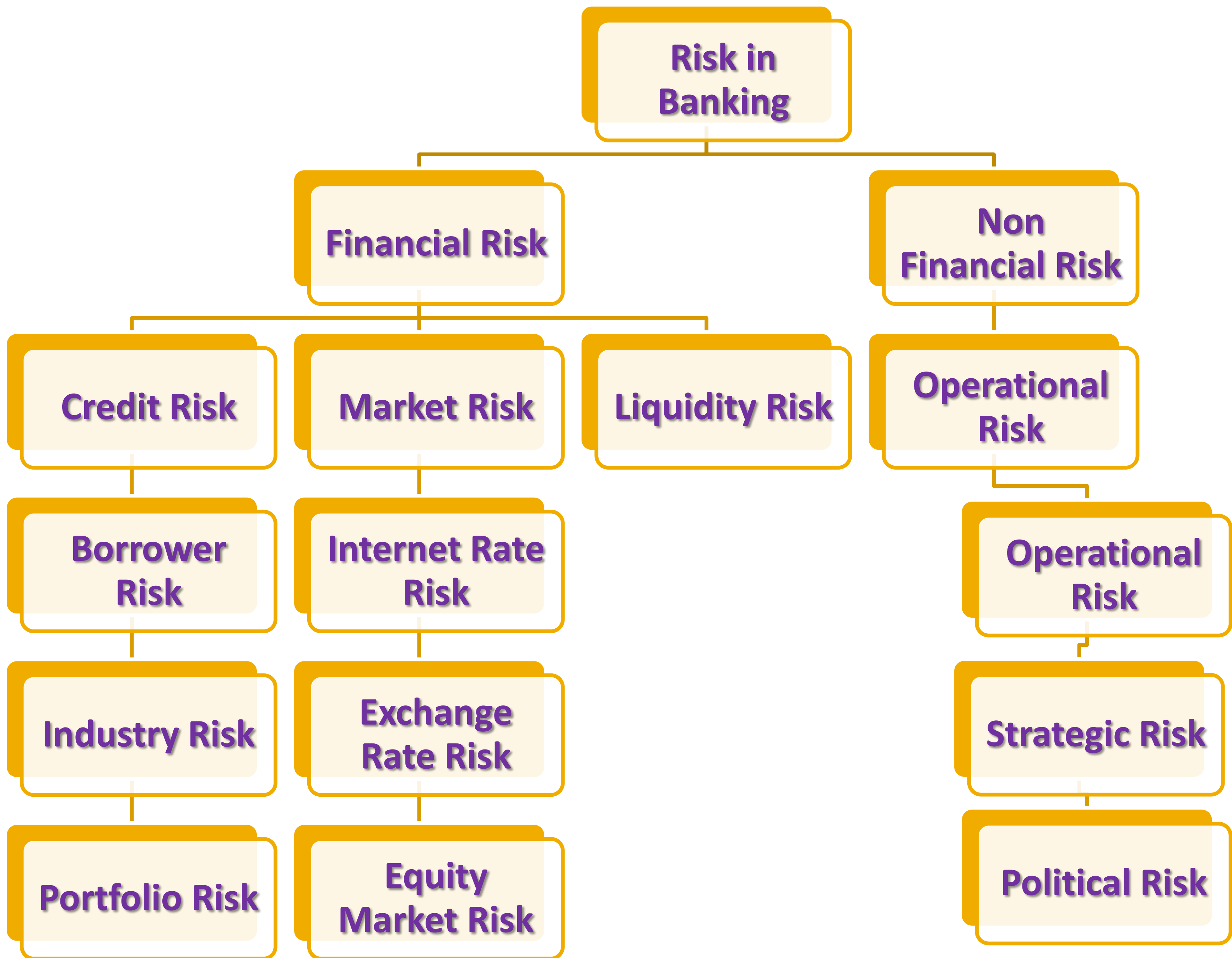
RISK MANAGEMENT

- What is Risk ?
  - Uncertainty of future outcome.
  - Alternatively, probability of adverse outcome.

- What is Risk Management ?
  - Risk Management is the process of assessing risk and then developing strategies to mitigate it.

RISK IN BANKING SECTOR


Risk in Banking
Financial Risk
Non Financial Risk
Credit Risk
Market Risk
Liquidity Risk
Operational Risk
Borrower Risk
Internet Rate Risk
Operational Risk
Industry Risk
Exchange Rate Risk
Strategic Risk
Portfolio Risk
Equity Market Risk
Political Risk

Market Risk

Results From adverse movements in market prices

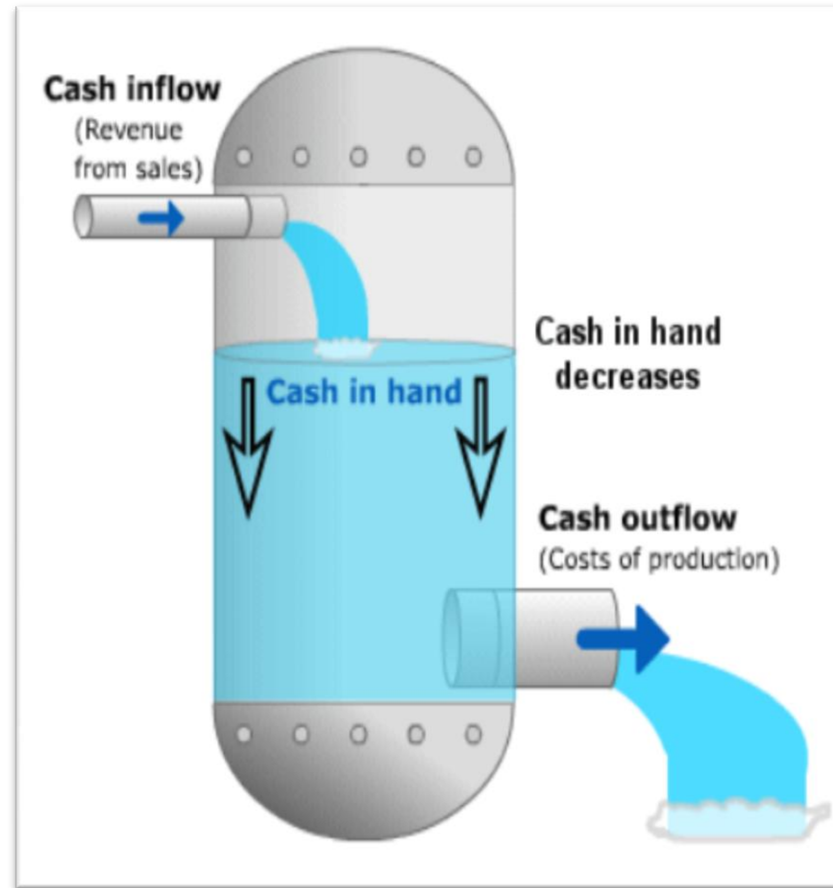
(1)Interest Rate Risk
(2)Equity Market Risk
(3)Exchange Rate Risk
(4) Commodity Price Risk

Credit Risk

(1) Borrower Risk
(2) Industry Risk
(3) Portfolio Risk

Liquidity Risk

(1) Bank unable to meet short term financial demands
(2) Caused due to inability to convert a security or hard asset to cash.
(3) Asset liability Mismatch



Operational Risk : Arises as a result of failure of operating system in the bank – like fraudulent activities, natural disaster, human error, omission or sabotage etc.

Systematic Risk : Failure of one financial institution spreads as chain reaction to financial system as a whole.

Reputation Risk : potential loss that negative publicity regarding an institution's business practices, will cause a decline in the customer base, costly litigation, or revenue reduction.

RISK ASSESSMENT

- It is the process of identifying and analyzing relevant risks to the achievement of the entity's objectives and determining the appropriate response.
- It implies :
  1. Risk identification
  2. Risk evaluation & quantification
  3. Risk appetite assessment
  4. Development of responses to risk.

CORE RISKS

- Asset Liability Management Risk
- Credit Risk Management
- Foreign Exchange Risk Management
- Money Laundering Prevention Risk (AML &CFT)
- Internal Control and Compliance Risk
- Information Technology Risk
- Environmental & Social Risk Management.

REASONS FOR ALM RISKS

- Weakness in analyzing Balance Sheet and other operations
- Absence of proper analysis of interest rate risk and liquidity risk
- Absence of contingency plan for unforeseen or unexpected change in interest rate, competitive market condition, economic development etc.
- Absence of proper counterparty limits.

KEY MANAGEMENT INDICATORS

CRR	SLR	Rest	Remarks
5.5% of DTL	13.00% of DTL	100%-5.5%-13%=81.5%	CRR and SLR are subject to change time to time by BB

Ideally Bank has to maintain 80-85% ADR ratio (Exception BKB and Islamic Banks)

$$ADR = \frac{\text{Total Loans and Advances or Investment}}{\text{Total Time and Demand Liabilities} + \text{InterBank Deposit surplus}}$$

KEY MANAGEMENT INDICATORS

- **<u>Whole sale borrowing (WB) Guidelines</u>:**

  The aim of wholesale borrowing(WB) guideline is to set a limit for borrowed fund.The limit should be set in absolute amount based on bank's eligible capital (Tier-1 plus Tier-2) and considering liquidity needs due to maturity mismatch, borrowing capacity of the Bank and historic market liquidity.

KEY MANAGEMENT INDICATORS

- **Commitment:**

  Absolute amount not exceeding 200% of unused wholesale borrowing capacity of the last 12 months.

- **Maximum Cumulative Outflow (MCO):**

  Ideally no single monthly bucket should exceed 20% of total balance sheet.

KEY MANAGEMENT INDICATORS

LCR or Liquidity Coverage Ratio is a liquidity standard for Banks. This standard is built on the methodologies of traditional liquidity coverage ratio used by banks to assess exposure to contingent liquidity events. The minimum acceptable value of this ratio is 100 percent.

$$\text{LCR} = \frac{\text{Stock of high quality assets}}{\text{Total net cash out flows over the next 30 calender days}} > 100\%$$

High Quality Assets: That consists of cash or assets that can be converted into cash at little or no loss of value in market.

KEY MANAGEMENT INDICATORS

NSFR or Net Stable Funding Ratio is another new standard introduced by the BCBS. The NSFR aims to limit over-reliance on short-term wholesale funding during times of abundant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items. The minimum acceptable value of this ratio is 100 percent, indicating that available stable funding (ASF) should be at least equal to required stable funding (RSF).

$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

Stable Funding: Non reliance of short term wholesale funding.

CREDIT RISK MANAGEMENT

POLICY GUIDELINES

All banks should have established Credit Policies (" Lending Guidelines ") that clearly states the senior management's view of business development policies and terms and conditions for loans to approve.

The lending guidelines should provide the following:

- **Industry and Business Segment Focus**
  - ✓ **Lending Guidelines should Clearly identify the business industry sectors of the banks loan portfolio.**

- **Types of loan Facilities**
  - ✓ **The type of loans should be clearly indicated such as Working Capital, Trade financing, Term loan, etc**

- **Single Borrowers/Group Limits/ Syndication**
  - ✓ **Single Borrower/g Group limits should be included as per Bangladesh Bank guidelines**

POLICY GUIDELINES

- **Lending Caps**
  - ✓ Banks should establish a specific industry sector exposure cap to avoid over concentration in any one industry sector
- **Discouraged Business Types**
  - ✓ Banks should outline industries or lending a activities that are discouraged.
- **Loan Facility Parameters**
  - ✓ Facility parameters (e.g maximum size, tenor, and covenant and security requirements) should be clearly stated
- **Cross Border Risk**
  - ✓ Risk associated with cross border lending.

CREDIT ASSESSMENT

A through credit and risk assessment should be conducted prior to the granting of loans. Credit Applications should include the following details:

- Amount and types of loan proposed
- Purpose of loans
- Loan structure (Tenor, Covenants, Repayment Schedule, Interest)
- Security arrangements

Credit Assessment cont..

- In addition , the following risk areas should be addressed:
- Borrower Analysis
- Industry Analysis
- Supplier/ Buyer Analysis
- Financial Analysis
- Projected Financial Performance Adherence to Lending Guidelines
- Mitigating Factors
- Loan Structure
- Security

Approval Authority:

The authority to sanction/ approve loans must be clearly delegated to senior credit executives by the Managing Director/ CEO & Board

Segregation of Duties:

- Credit Approval / Risk Management
- Relationship Management / Marketing
- Credit Administration

Internal Audit:

Banks should have a segregated internal audit/ control department charged with conducting audits of all departments

Money Laundering Risk

How is Money Laundered

- **MONEY LAUNDERING IS NOT A SINGLE ACT BUT A PROCESS ACCOMPLISHED 3 BASIC STAGE :**
- ***Placement:*** **Physically disposing of the Cash.**
- ***Layering*:** **Separating the criminal proceeds from sources via complex financial transactions.**
- ***Integration:*** **Placing the laundered process back into the economy .**

A TYPICAL MONEY LAUNDERING PROCESS

Trade Based Money Laundering

- Trade-based money laundering is a growing concern for the banking industry amid rapid expansion of foreign trade. More than 80% money laundered through TML.
- Among the trade-based money laundering techniques, over- and under-invoicing of goods and services and false declaration of goods are commonly used in Bangladesh banks found.
- Money laundering is facilitated by collusion between importers and exporters and bank officials are sometimes forced to get involved in the illegal transactions

Possible Areas to Monitor

- Transaction type
- Frequency
- Unusually large amount
- Geographical origin / destination
- Changes in account signatories

Internal control and compliance

- **Definition of Internal Control :**
- Internal control is the process, that is put into effect by an organization's board of directors, management and other personnel, and is designed to provide reasonable assurance regarding the achievement of objectives in the effectiveness and efficiency of operations, the reliability of financial reporting and compliance with applicable laws, regulations and internal policies.

FOREIGN EXCHANGE RISK MANAGEMENT

Operational & Performance Objectives

- ***Compliance with Foreign Exchange Regulations***
- ***Liquidity***
- ***Transactions***
- ***Monitoring***
- ***Reconciliation***

2. Foreign Exchange-based Operations

Risk Associated with Foreign Exchange Operations

The key risk areas are broadly categorized as follows:

1. Credit Risk

This is defined as the failure of an obligor or counter-party to perform as agreed in accordance with exchange/settlement arrangements on a stipulated/value date.

2. Liquidity Risk

It is defined as the inability to meet obligations in any currency when due, owing to either lack of funds by either of the contracting parties or to systemic problems in markets that make it difficult to purchase the amounts needed for settlement. Accordingly, there is a close relationship between liquidity and credit risks.

3. Market Risk

It is defined as the potentially adverse change in the current economic value of a position (i.e., its market value) due to changes in the associated underlying market risk factors.

Treasury Activities

Treasury activities can normally be categorized into four areas:

Money Market

This refers to the day-to-day activities where the Bank addresses its short-term cash requirements, by either lending/investing its excess liquidity or borrowing to cover liquidity short-falls.

Fixed Income

This refers to a sub-set of the investment universe where instruments with fixed pricing are the traded commodities.

Foreign Exchange

This refers to the buying and selling of funds denominated in various currencies, where the Bank may dispose of its excess stock or purchase its operational requirements (e.g., to settle L/C transactions).

Asset-Liability Management

This refers to the Treasury functions that are associated with the execution of ALM strategies.

Remittance Activities:

A major source of the Bank's foreign exchange is the inward remittances from overseas by migrant workers, non-resident nationals, etc., as well as export proceeds. It is therefore the Bank's duty to handle these funds with care and efficiency in order to: to protect its reputation as a reliable remittance channel; ensure that money-laundering is prevented; and maintain liquidity.

In million USD

Year	Export	Import	Trade Balance	Remittance	(Export+ Remittance- Import)	Overall BOP
2014-15	31,208.94	40,703.70	-9,494.76	15,316.91	5822.15	2854.601
2015-16	34,257.18	43,122.50	-8,865.32	14,931.15	6065.83	4649.18
2016-17	34,655.90	47,005.20	-12,349.30	12,769.45	420.15	-5320.93
2017-18	36,668.17	58,865.30	-22,197.13	14,978.86	-7218.27	-885
2018-19 (Jul-Sep)	9,940.60	13,599.00	-3658.40	3868.89	210.49	-720

ICT Risk Management

OBJECTIVE

The objective is to accomplish mission(s):

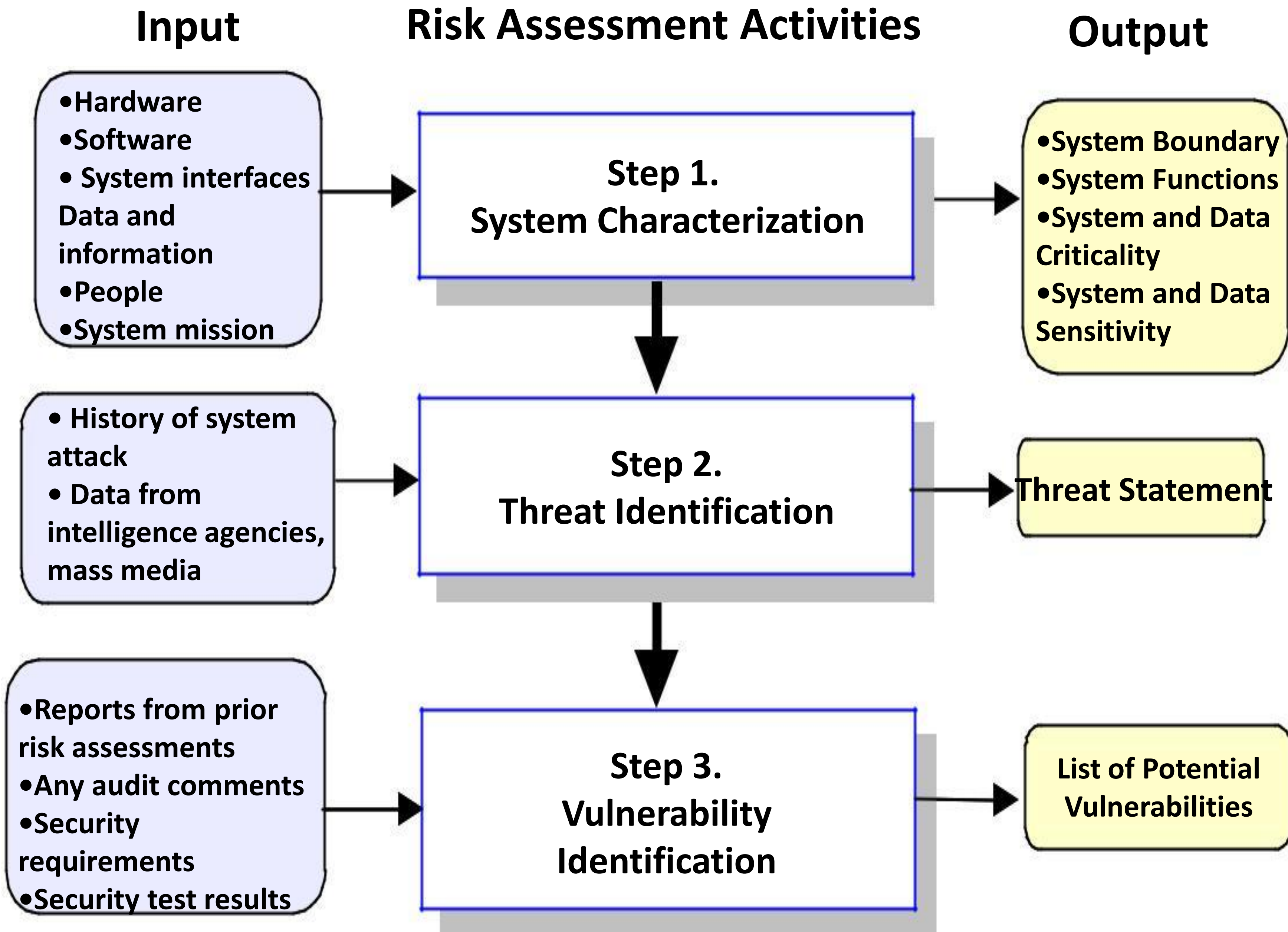
(1) By better securing the ICT systems that store, process, or transmit organizational information;

(2) By enabling management to make well-informed risk management decisions to justify the expenditures that are part of an ICT budget; and

(3) By assisting management in authorizing (or accrediting) the ICT systems on the basis of the supporting documentation resulting from the performance of risk management.

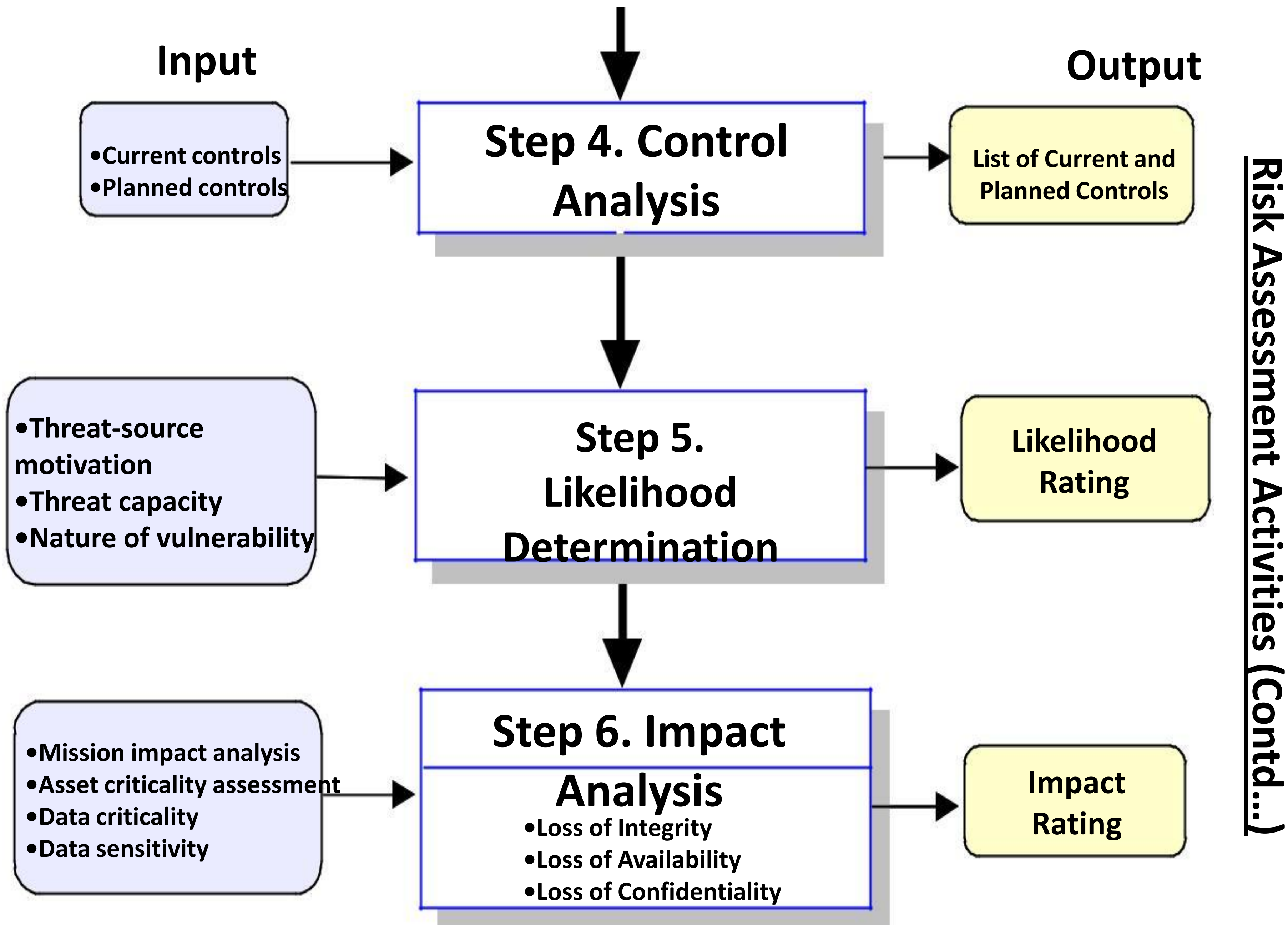
ICT RISK Possibilities

- **Network Risk - Improper Configuration, Authentication etc.**
- **Data Centre Risk - Server Failure, Monitoring Failure etc.**
- **Hardware Risk – Power Faults, Equipment Incompatibilities, damage etc.**
- **New Purchased Software Risk- Software with Limitations, Functionality Mismatch etc.**



Risk Assessment Methodology Flowchart (part-1)

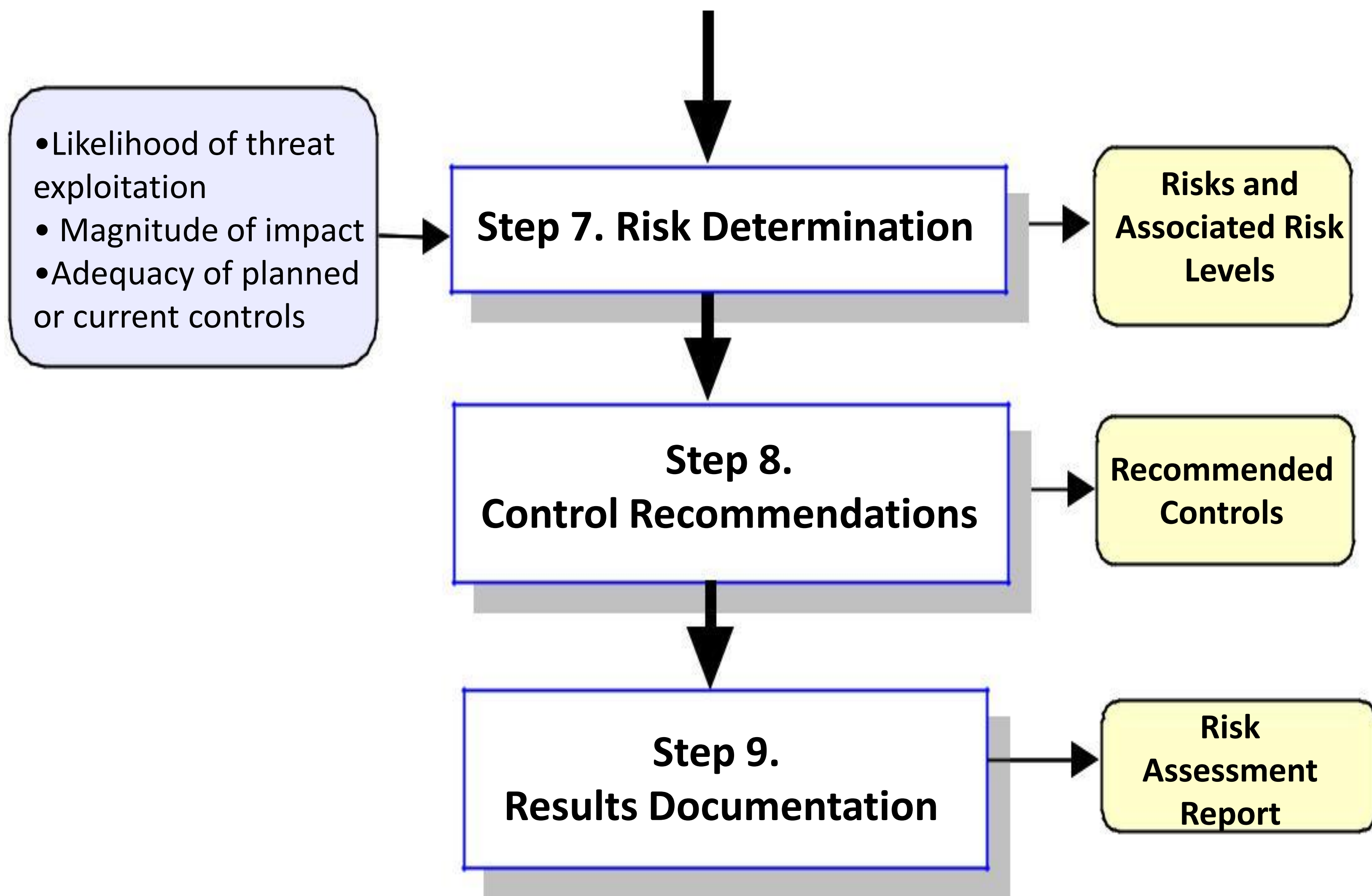
Risk Assessment Activities (Contd..)



Risk Assessment Methodology Flowchart (part – 2)

Risk Assessment Activities (Contd…)

Input **Risk Assessment Activities** **Output**



Risk Assessment Methodology Flowchart (part-3)

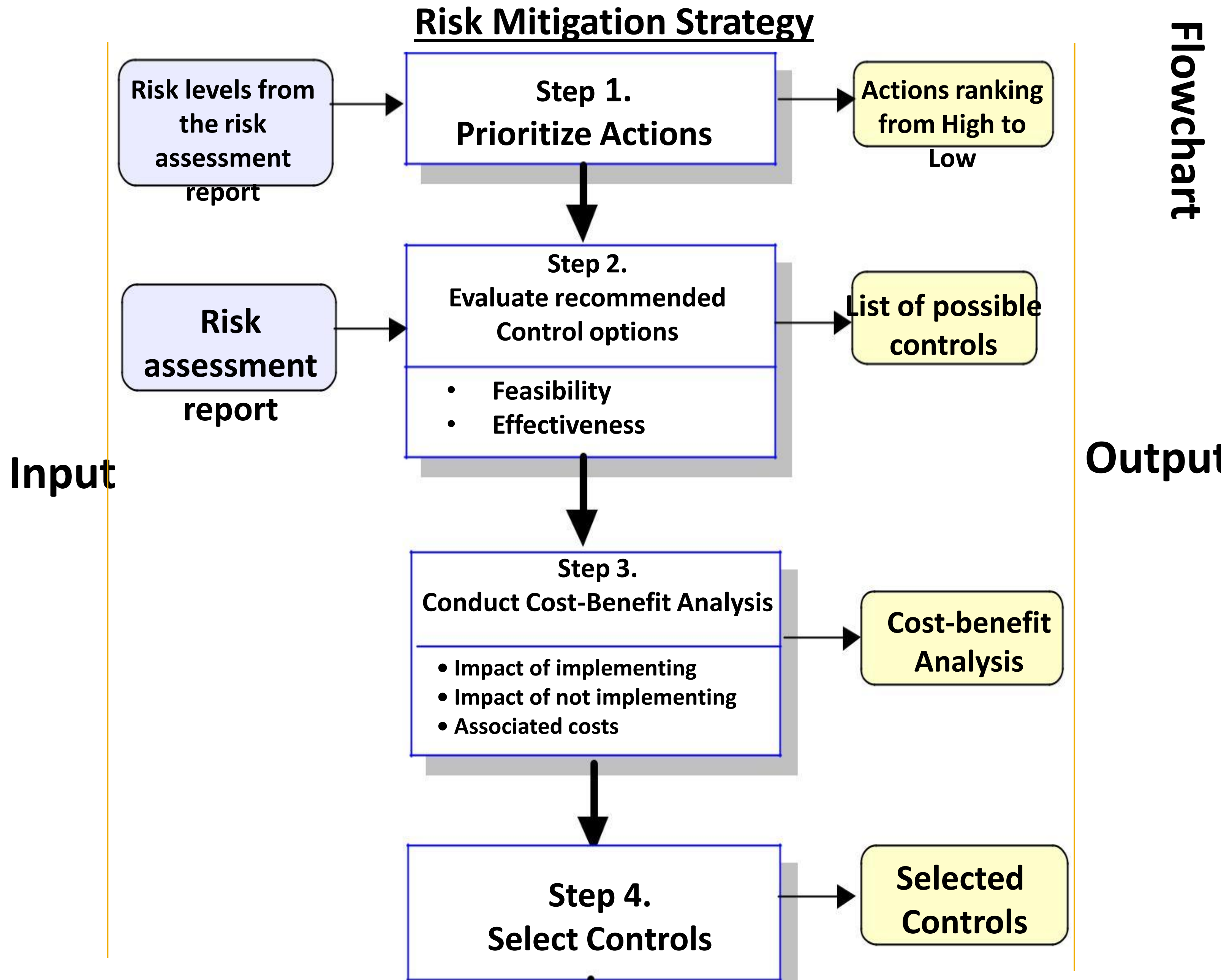
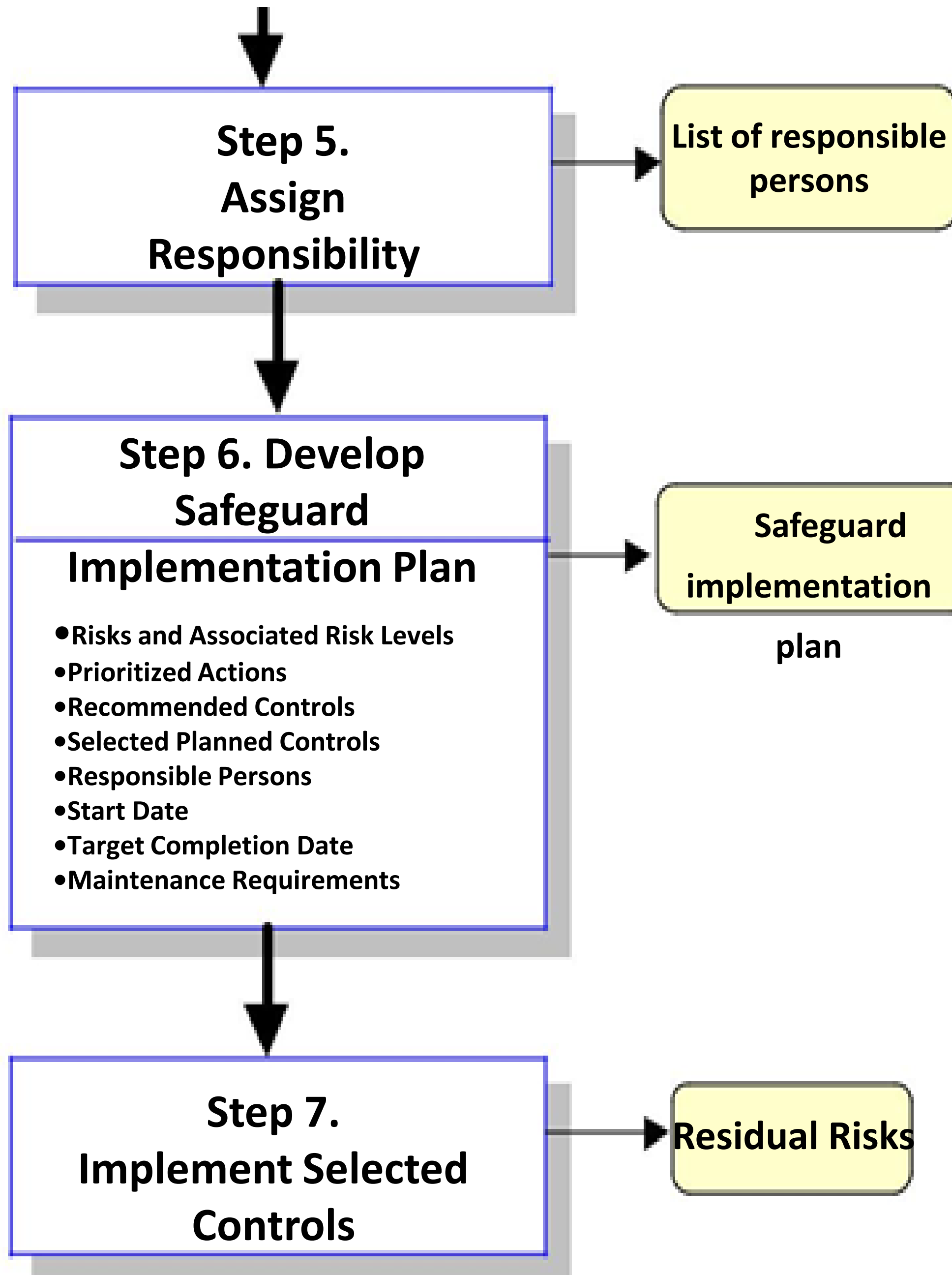


Figure 5-2. Risk Mitigation Methodology Flowchart

Input



Output

Figure 5-2. Risk Mitigation Methodology Flowchart

Environmental & Social Risk Management (ESRM)

Sustainable Development has been increasingly being recognized to the growth. New standards and codes of conduct have been developed towards ESRM within the Banking sector to promote corporate accountability on the impacts of Business on environment and society. From the perspective of Banking sector ,the role of ESRM is aimed to reduce the probability of default.

To reduce exposure to risk arising from the E & S risks of their clients. Banks need to ensure that their clients' financial and operational sustainability is not undermined by adverse impacts on the environment and surrounding communities. Banks need to have a clear understanding of potential E&S risks and implications for a client's operations prior to being linked to the client in the context of transactions.

Risks associated with E&S Risk in Credit Management:

- Banks are exposed to some level of E&S risk through their clients. If left unmanaged, these risks can lead to a decline in the Bank/FI's reputational image, costly litigation, or loss of revenue.

- The type, quantity and severity of E&S issues that present a risk to a Bank for any given transaction depend on a variety of factors, including geographic context, industry sector, and the type of transaction: corporate, real estate, insurance, leasing, microfinance, project finance, retail, short-term finance, micro, small and medium enterprise and trade.

- **Credit risk:**

A Bank is exposed to credit risk when a client is unwilling and/or unable to fulfill the contractual obligations associated with a transaction as a result of E&S issues. For example, if a client faces increased capital or operating costs of complying with E&S standards or if operating and emission/discharge permits are absent or expired resulting in regulatory fines or penalties, there is a risk that the client cannot meet its financial obligations

- **Legal risk:**

By virtue of taking possession of collateral assets, a Bank/FI is exposed to liability risk stemming from a client's legal obligations. This includes fines, penalties, and costs for addressing third-party claims for damages due to negligence in managing E&S risks in a client's operations and clean-up of contamination.

•Operational risk:

A Bank is exposed to financial risk stemming from potential disruption of client’s operations as a result of E&S problems. If not managed properly, these problems can affect a client’ stability to meet its financial obligations to the Bank or can drive down the value of a client’s collateral in the context of a transaction.

- **Liquidity risk:**

The Bank will also face liquidity risks from E&S problems associated with collateral. For example, the Bank/FI will have to use up internal resources to meet government clean-up requirements or to clean the site up before it can be sold if collateral is contaminated.

- **Reputational risk:**

  A Bank/FI is exposed to reputational risk due to potentially negative publicity associated with a client's poor E&S practices. This harms a Bank/FI's brand value and image in the media, with the public, with the business and financial community, and even with its own staff. For example, if a client faces strong public opposition against its operations, the Bank/FI's reputation may be tarnished through its association with this particular client.

THANK YOU