Indian Banking at Crossroads – Challenge of Risk Management from Globalisation to Financial Inclusion[@]

Shri Shailesh Vaidya, Chairman, Indian Merchants' Chamber (IMC), Shri Chandan Bhattacharya, Chairman, Finance and Banking Committee, IMC and delegates to this IMC National Seminar, a very warm good evening! It is an honour for me to be here today to deliver the valedictory address of this National Seminar organised by IMC. The Seminar provides an opportunity to consider the developments in the banking risk management, assess the recent experience in this space and work on the way ahead.

Why risk management assumes greater significance in banks

2. Most business activities and operations are driven by considerations of returns or profitability. However the search for returns exposes the businesses to risks. Also risks escalate and multiply with returns sought – banks are no different; only the element of riskiness in the banks' business and operations is higher as they not only carry out their operations with borrowed money and with high leverage but also attempt to provide a vast range of financial services.

3. Banks perform multifarious functions. However financial intermediation and maturity transformation are by far the most significant

activities performed by banks. Banks essentially have a liquid liability profile, as against an illiquid asset profile, which makes them vulnerable to runs and in this process alone, they generate or are exposed to different types of risks. Credit, market and operational risks are the three primary risks that have a substantial bearing on the performance of banks. There are a number of other types of risks, emanating both from within and without that the banks are exposed to in their day to day functioning.

4. Further, banks are intricately linked to the various segments in the financial sector and the economy. Problems emanating from the banking sector can cause wide spread destabilization to the segments to which it is, directly or indirectly linked.

5. As the banks perform this role of intermediation in fiduciary capacity, ensuring a balance between the risks and returns assumes significance and the effort towards achieving this balance can be referred to as risk management. The various financial crisis of the past brought to the fore the importance of robust risk management practices in financial institutions including banks. Progressive technological developments and advanced modelling techniques have, however, rendered risk management a highly complex and sophisticated discipline lately.

What is Risk Management?

6. Risk management can be defined as a function of risk identification, measurement, monitoring and reporting to ensure that the returns are appropriate to the risk undertaken and the risks undertaken are commensurate with the risk appetite and risk tolerance. Risk management has to ensure that the bank holds adequate capital and reserves to make sure that its solvency and stability are not threatened, both in the short and the long run.

7. The capital measurement standards commonly known as the Basel Accords I and II published in 1988 and 2006 respectively, had already emphasized the importance of risk management by linking progressively the banks' capital adequacy to the risk weighted assets (RWA) on account of the Credit and RWA equivalent for Market and Operational risks. Based on the principle of proportionality, Basel II further entails progressive advancement to sophisticated but complex risk measurement and management approaches to credit, market and operational risks depending on the size, sophistication and complexity of the respective banks. In addition, Pillar 2 and Pillar 3 of Basel II emphasize the need for developing better risk management techniques in monitoring and managing risks not adequately covered or quantifiable under Pillar 1 and increased disclosure requirements.

Recent global initiatives for strengthening risk management practices in banks

8. As a response to the global financial crisis, a package of reforms collectively referred to as Basel III has been unleashed as part of the global regulatory effort to enhance the soundness and resilience of the banking system. These reforms focus on capital, liquidity, leverage and macro prudential aspects of banking risk management. Basel III, on one hand, attempts to improve the quality and quantity of loss absorbing capital that a bank holds and aims at increasing the risk coverage of the capital framework, in particular for trading activities, securitisations exposures to off-balance sheet vehicles and counterparty credit exposures arising out of derivatives. On the other hand, it has devised regulation for dealing with systemic risk by prescribing countercyclical capital requirement, to contain pro-cyclicality and a framework for G-SIBs and D-SIBs has also been laid down to manage risks arising from inter-connectedness.

9. The reforms require banks to raise the amount of common equity to 4.5% of assets by January 2019 from the 2% requirement under Basel II. The new minimum for Tier 1 capital has now been raised to 6%. The innovative elements of the Basel III requirements include additional layers of capital in form of the Capital Conservation Buffer and Countercyclical Capital Buffer, minimum Liquidity requirements in the

form of short term Liquidity Coverage Ratio (LCR) and long term structural Net Stable Funding Ratio (NSFR), a leverage ratio as a back-stop to the risk based capital framework and additional proposals for the Global Systemically Important Banks (G-SIBs). The Capital Conservation Buffer is prescribed as 2.5% of common equity in addition to the 4.5% minimum requirement bringing the total common equity requirements to 7% which if breached would restrict pay-outs of earnings to help protect the minimum common equity requirement. The capital buffer can be used to absorb losses during periods of financial and economic stress. The countercyclical capital buffer entails common equity or other fully loss absorbing capital in the range of 0% – 2.5% to be implemented according to national circumstances and kicks in when credit to GDP ratio deviates significantly from the trend. The paradigm changing approach to risk management under Basel III is introducing macro-prudential regulations to deal with systemic risk. The crisis brought home the point that even while individual financial institutions are strong, when each of them act to preserve its own interests, these actions could lead to instability of the system.

10. An internationally harmonised Leverage Ratio has been introduced as a simple back-stop facility to complement the risk based capital framework in order to contain build-up of excessive leverage in the

system and comprises of 3% loss absorbing capital relative to all of a bank's assets, including off-balance sheet assets without risk weighting. Certain enhancements have also been introduced to the Basel II framework by raising standards for the supervisory review process and public disclosures under Pillar 2 and 3, together with additional guidance in the areas of sound valuation practices, stress testing, liquidity risk management, corporate governance and compensation. The liquidity requirements include a minimum liquidity coverage ratio (LCR) intended to provide enough cash to cover funding needs over a 30-day period of stress. As such under LCR, the banks will be required to hold a buffer of high-quality liquid assets sufficient to deal with cash outflows encountered in acute short-term stress scenario. At the long-term spectrum, the net stable funding ratio (NSFR) is intended to address maturity mismatches over the entire balance sheet for upto one year and provides incentives for banks to use stable sources to fund their activities. The proposals for the G-SIBS are tougher, to include combinations of capital surcharges, contingent capital and bail-in debt as also strengthened arrangements for cross border supervision and resolution in view of the higher complexity, connectedness and riskiness. Keeping in view the need to safeguard against any disruption to the recovery of the real economy and allow national jurisdictions sufficient time to translate the new standards into national legislation, a transition phase of six years from 1 January 2013 to 1 January 2019 has been envisioned for full implementation.

Recent developments and emerging regulatory scenario in India for improving risk management in banks

11. The Reserve Bank too has adopted a proactive and calibrated approach towards demanding and facilitating robust risk management efforts by the banks. Reserve Bank has been adopting a considered approach of limiting the systemic risk originating from both the pro-cyclicality as well as interconnectedness dimensions. For example, countercyclical measures were adopted as early as 2004 to stall heating up of certain specific sectors by increasing the risk weights and provisioning ratios for sensitive sectors such as capital market, housing, commercial real estate during the period when the boom was building up. Several measures were taken to reduce the inter-connectedness among banks on the one hand and between banks and NBFCs on the other, to address the cross-sectional dimension of systemic risk and regulatory limits have been placed on exposures to capital market exposures. Such macro-prudential approach, which was not widely prevalent then, saved the domestic economy from the adverse shocks during the height of the crisis.

12. The road-map for the implementation of Basel II in India was in phases and was designed to suit the country-specific conditions.

BASLE III

13. Implementation of Basel III Capital Regulations has commenced in India from April 1, 2013; and it will also be in phases, and would be fully implemented as on March 31, 2019 close to the internationally agreed Basel III transitional arrangement.

i. As against the minimum Tier 1 **leverage ratio** of 3 per cent proposed by the Basel Committee of Banking Supervision (Basel Committee) during the parallel run period beginning from January 1, 2013 to January 1, 2017, the Reserve bank has prescribed a minimum Tier 1 leverage ratio of 4.5 per cent during the parallel run period. The leverage ratio framework is being revised in line with the recent proposals of the Basel Committee.

ii. The Reserve Bank has issued enhanced **Pillar 3 disclosure requirements** effective from quarter ended September 30, 2013 to improve transparency of regulatory capital and to enhance market discipline.

iii. Comprehensive **liquidity risk management (LRM)** guidelines were issued on November 7, 2012. Based on the recent guidelines published by the Basel Committee on Liquidity Coverage Ratio (LCR) in

January 2013, the Reserve Bank is in the process of finalizing its guidelines on LCR which are expected to be issued shortly.

iv. The guidelines issued by the Reserve Bank on July 2, 2013 (effective January 1, 2014) on capital requirements for bank exposures to CCPs provide incentives for banks to clear standardised **OTC derivatives** contracts through qualified central counterparties.

v. While none of the Indian banks figure in the list of G-SIBs, **domestic SIBs** have to be identified. A draft framework for dealing with the D-SIBs has been published on December 2, 2013. It requires that additional common equity capital requirement applicable to a D-SIB with highest systemic importance will be 0.8% of RWAs.

vi. The Reserve Bank revised its guidelines on **securitisation** in May 2012 and introduced norms on minimum holding period, minimum retention ratio, and standards for due diligence to align the interest of the originators and investors, and induce ‘Skin in the Game’ concept to discourage ‘Originate to Distribute’ models.

vii. **Un-hedged foreign currency exposures (UFCE)** of the corporates are a cause of concern as they pose risk to the individual corporates as also to the entire financial system. Guidelines on risk management of un-hedged exposures as also the methodology to be followed by banks for computing incremental provisioning and capital requirements for exposure to corporates having un-hedged foreign currency exposures have since been introduced.

viii. As a prudential measure aimed at avoiding concentration of credit risk and large losses due to **Intra-Group Transactions and Exposures (ITEs)**, the Reserve Bank of India has prescribed regulatory guidelines on February 11, 2014, putting in place both quantitative limits for the financial Intra-Group Transactions and Exposures and prudential measures for the non-financial ITEs.

ix. As the growing volume of non - performing assets along with restructured assets was becoming a major cause for concern for the financial as well as the real sector, a **framework for revitalizing distressed assets** in the economy has been implemented with effect from April 1, 2014. The Framework lays down guidelines for early recognition of financial distress, information sharing among lenders and co-ordinated steps for prompt resolution and fair recovery for lenders. It envisages *centralised reporting* and dissemination of information on large credits, early *formation of lenders' forums* and *incentives* for lenders and borrowers to agree on resolution and *disincentives* for both in the event of failure to act in a timely way. Improvements in the current restructuring process such as an *independent evaluation* of large value restructuring with a focus on viability and fair sharing of gains and losses between promoters and creditors have been mandated. Finally, a more *liberal regulatory treatment* of distressed asset sales, particularly to asset reconstruction companies, has been provided. It proposes to bring non-bank lenders also under its ambit for enhanced effectiveness.

x. The Basel Committee issued the Principles for Sound Stress Testing Practices and Supervision in May 2009. In tune with these principles, the extant Reserve Bank guidelines on **stress testing** have been updated. Stress testing which is based on forward looking approach is expected to provide a complementary and independent risk perspective to other risk management tools such as value-at-risk (VaR) and economic capital and complement risk management approaches that are based on complex, quantitative models using backward looking data and estimated statistical relationships.

xi. With the objective of building up a buffer of capital which can be used to achieve the broader macro-prudential goal of restricting the banking sector from indiscriminate lending in the periods of excess credit growth that have often been associated with the building up of system-wide risk, the Reserve Bank has proposed to create a **Countercyclical Capital Buffer (CCCB)** framework for banks in India. The proposed draft CCCB framework in India is based upon the credit-to-GDP gap in conjunction with other indicators like Gross Non-Performing Assets (GNPA) growth. The CCCB shall increase linearly from 0 to 2.5 per cent of the risk weighted assets (RWA) of the bank based on the position of gap between 3 percentage points and 15 percentage points.

xii. The Reserve Bank is keen to introduce a **countercyclical provisioning** approach with the objective of building up provisioning buffer for the banking system when the banks in general are making profits so that this can be used to absorb losses in case of downturn. A discussion paper on Introduction of **Dynamic Loan Loss Provisioning** Framework for Banks in India has been put on the RBI website on March 30, 2012. A comprehensive forward looking provisioning framework based on data collected from select banks in respect of certain segments and system–wide data is being developed. The new approach would smoothen the impact of incurred losses on the Profit and Loss Account through the cycle and thereby facilitate continued lending by banks during downturns.

xiii. The Reserve Bank has from time to time also issued regulatory guidelines on other areas such as **Corporate Governance, Fit & Proper, Know Your Customer/Anti Money Laundering, Credit Information Sharing, Customer Services** in addition to specific guidance on credit, market and operational risk management etc., to strengthen the over-all risk management culture in Indian banks.

Recent risk management in banks

14. A survey on banking risk management, conducted under the aegis of the Institute of International Finance, sees a renewed focus on risk culture. It reports that risk culture is now at centre stage and banks have made significant progress toward changing their risk governance frameworks in the wake of the financial crisis. Board risk committees are nearly universal, and members have received appropriate training in risk management. The role of the chief risk officer has broadened, while its seniority and status have been enhanced. They now report either to the chief executive officer or jointly to the CEO and risk committee. However, the survey laments that the industry continues to wrestle with the process of embedding risk culture beyond the boardroom and into business units while ensuring adequate risk transparency.

15. Many respondents cited the balance between a sales-driven front-office culture and a risk-focused culture at higher levels as their top organizational challenge; they also note lack of systems and data. They believe their organizations need to do more to instill a strong risk culture, underscoring the need for a sustained effort over a long period of time.

16. Risk appetite continues to be an essential part of risk governance, but the industry continues to be challenged to embed risk appetite into business decisions. The financial services industry recognized during the financial crisis that boards needed to change focus from share price and profitability to the risks entailed in their strategies. Also, chief risk

officers needed to be empowered to create cultural change within their organizations.

17. With these shifts well underway, senior risk executives are focused on moving reputation and operational risk higher up the agenda. However, banks are still struggling to ensure that specific business decisions are consistent with risk appetite and are putting new programs in place to achieve this.

18. One of the challenges that banks face in developing comprehensive risk measurement models are the scarcity of available historical and time series loss data and the quality, completeness and reliability of the data available. Effective risk management requires specialisation and technical expertise as also independent and dedicated risk management function. While efforts are on in this direction, the HR policies and limited suitable number of the skilled human resources present myriad challenges in fully achieving this objective. Attrition and ability to retain the skilled personnel adds to the challenge.

Present experience in risk management in Indian banks

19. The regulatory initiatives as also the banks' individual efforts in this direction have certainly improved the risk management standards in Indian banks in the last few years. Since the initiation of structural reforms in the Indian banking sector in 1991, the reach and business

volumes of Indian banks have increased many fold; the operations have grown and assumed higher degree of sophistication. The Indian banks' current capital base and liquidity position are broadly comfortable, as a starting point, *vis-a-vis* the Basel III guidelines. Both the capital to risk weighted assets ratio (CRAR) and the core CRAR of Indian banks, respectively stood at 10.42 per cent and 9.24 per cent respectively as on March 31, 1997 and have consistently remained well above the regulatory requirement of 9 per cent and 6 per cent, respectively under Basel II. The CRAR and core CRAR were at 13.88 per cent and 9.7 per cent respectively as at March 31, 2013. Indian banks, thus, start from a position of strength in the process of transition to Basel III regime. Many challenges, however, still lie ahead and I shall touch upon these in a little while.

20. Asset quality is an important parameter to measure the health of the banks and concomitant with asset quality is the provisioning coverage that banks hold against stressed assets. Asset quality of the Indian banking system had improved significantly since introduction of prudential norms, SARFAESI Act, CDR Mechanism, Credit Information Companies, etc. The GNPAs ratio had steadily declined from 15.7 per cent in 1996-97 to 2.35 percent in 2010-11. However, as fallout of the global financial crisis and the consequent headwinds from many

advanced nations in the west, the GNPAs have risen to 2.94 per cent as on March 2012 and further to 3.42 per cent as at the end of March 2013. As per the provisional data, as on December 2013, the GNPA ratio was at 4.47 per cent. The ratio of restructured standard advances to gross advances stood at 5.8 per cent at end-March 2013 adding to the total stress.

21. All Indian banks, including foreign banks in India, migrated to the standardized approaches of Basel II by March 31, 2009 in two phases. Large sized Indian banks and banks with international presence have been encouraged to adopt the Basel II advanced approaches for computation of capital for credit, market and operational risk. Out of the 14 banks that submitted applications for migration to the Internal Rating Based approach for credit risk, seven have been given approval for parallel run. Under operational risk, parallel run has been approved for two banks for The Standardized Approach (TSA) out of the 13 banks that applied. Ten banks have so far conveyed their intent for migration to the Advanced Measurement Approach (AMA) of which cases of four large banks which made preliminary submissions in this regard are under different stages of examination. In respect of Market Risk, eight banks have conveyed their intent for migration to the Internal Model Approach.

22. There is, however, another very significant aspect of the bank operations, just as in any corporate entity, and that is the commercial aspect viz., profitability management. Profitability in banks, as in the corporates, is reflective of the financial well-being, health and robustness of the entity and has a direct bearing on its capital formation ability. On the flip side, if the bank's strategies, business models, planning and operations and risk management are weak, obsolete or outdated or not in tune with the macro-economic environment, the income flowing there from may be low or may end up in losses. Profitability is impacted by the business decisions of the bank, the business model it pursues, quality and type of asset base as also by operational efficiencies and any noteworthy shift in its strategies and policies. The risk profile of a bank can also be gauged from its income and expenditure statement to a great extent. However, currently alignment of the risk management and profitability management objectives is not so much in focus.

23. Since the profitability or the income and expenditure plans and decisions of the banks are directly connected to the regulatory concerns of capital adequacy and solvency as also the stability and soundness of banks, it is incumbent on the banks and the supervisors to carefully analyse the components of income and expenditure. A careful analysis and comparison of these streams of income and expenses would provide the bank an in-depth understanding of its business focus,

structure and stability of profits and serve as the guiding principles for rebalancing and / restructuring its balance sheet. This would enable a bank to not only, derive optimum earnings, rationalize cost and expenses but also to initiate changes in and diversify its business design / model in alignment with the industry or the current and profitable market practices.

The way ahead

24. Over the years and especially in the wake of the learnings from the global financial crisis, banks have enhanced their efforts in the direction of improving risk management practices as I have enumerated earlier. However, going forward much work still remains.

i. Banks must pay greater attention to the risk governance aspects, wherein the boards must have full understanding of the risks, typical to the respective bank as also full involvement in designing appropriate policies and strategies for the risk management. For this purpose, risk appetite and risk tolerance levels must be clearly defined, keeping in past and forward looking view on likely internal and external risk environment.

ii. An independent risk management function headed by a Chief Risk Officer (CRO) with sufficient freedom and stature assumes critical importance. Banks must ensure that the board level risk committees as also the independent challenge function in form of internal and external audit / reviews are effective in the real sense and have the requisite understanding, resources and wherewithal to perform their responsibility in a meaningful way.

iii. Senior management of the banks must play a proactive role.; They should communicate the risk management policies, risk appetite and tolerance statement, risk management practices to the operational in-charges at the business units and corporate levels for proper understanding and compliance.

iv. These efforts need to be supplemented by a robust Management Information System (MIS) and information technology platforms to provide the board and the top management with timely, reliable and complete risk related information on the bank for effective decision making and decisive action taking.

v. 'Embededness' or 'Use Test' which entails use of inputs to and outputs from the quantitative models in enhancing quality risk management and decision making need better encouragement .

vi. Over-reliance on quantitative models can grossly under-estimate tail risks and it is necessary to also use expert judgement in dealing with risk estimation and management. Stress tests, as also reverse stress tests and back testing should be gainfully utilised as complements to model based risk estimation.

25. Before concluding I will like to relay what A.T. Kearney, a reputed international consultant, has got to say about risk management in banks. They believe that the framework for risk management in a bank is fundamentally no different today than it was prior to the credit crunch and recession. However, the risk function lacks certain business acumen, and continues to be considered a handbrake on growth. A.T. Kearney suggests that a return to managing risks - not ignoring them or believing they can be passed off - is the cure. I could not agree more.

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