pen ACCLAIMS

Volume 6, July 2019 ISSN 2581-5504

"Risk Management in Corporate Governance- with Special Reference to Banking Institution"

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Abstract[1]

Corporate governance is not a new regime for any sector whether it is banking institution or insurance sector etc. in India like any other country in the world. The banking companies have significant role in driving the economy of country. Proper functioning of these banking companies is therefore necessary for consistent contribution in the economy. The various changes in relation to corporate governance have been recommended from time to time to make functioning of business and commerce industry smooth and free from unethical and illegal practices of any kind. In recent year's various scams had happened wherein the role of the baking institutions is apparent and shows the malfunctioning because of the absence of proper and stringent legal regime. The different types of risk in the banking sector therefore require different means and modes to take the preventive action and punitive action on the part of the various regulators like Reserve Bank of India etc. It is right to focus on the effectiveness of banking sector as well by bringing the good governance system in the country. RBI regulation to govern the banking sector is therefore to be analyzed for making the effective changes to make the functioning of baking companies effective. The Basel Committee also has important role to be played in the governance of the banking sector and therefore it will be analyzed whether the changes it has brought to meet with the OCED convention are effective enough to deal with the current banking malpractices or not. The likely suggestions will be made on the basis of critical analysis of these different regulators of the banking sector for further effective governance of the baking companies and to meet the international standard of governance set though OCED principles.

Introduction

The main object of corporate governance in banks is to protect the interest of the stakeholders from risk. As per ***International Standard Organisation 31000*** "*Risk is effect of uncertainties on the objects which is followed by coordinated and economical application of resources to minimize, monitor and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities*"[2].Effective corporate governance helps in proper allocation of responsibility and authority to board and senior management who carry affairs of business.

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[2] Tara, S., Sadri, S., 2015. Corporate Governance and Risk Management: An Indian Perspective. *International Journal of Management Science and Business Administration*. Volume 1, Issue 9, Pages 33-39.

Board is responsible for identifying risk at early stage and thereby assess consequences of risk and ways in which it can be avoided and therefore selecting best measures for avoidance of identified risk. Risk management in banking institutions and thereby bringing good corporate governance culture in banks is also governed by ***OCED*[3] *principles*** which are followed in various regulations of government. Types of risk involved in banks and regulations governing risk management practice in India and obligation under OCED Principles are focused for assignment.

Type of Risk Involved in Banking Sector of India

There is a need of attentive and efficient board for risk management and thereby to develop good governance system in banks since it is based on trust of customers, reputation of brand and dangerous leverage. Board must identify nature of risk, exposure of it and effective ways to deal with it. Post introduction of LPG[4] in India, deregulation of banking sector by government has resulted in more focus on risk management by banks at their individual levels. There are three essential components of risk management: *Risk Identification***,** nature of risk associated with product and service is identified under this process. *Risk Management,* estimation of potential loss is identified under this process and *Risk Control,* framing policy planes for limiting risk[5].

Types of Risk Involved in Banking Institution and ways to manage the Risk:

1. **Liquidity Risk:**

It arises when there are chances that bank will not be able to meet its commitment when they will become due. It includes, *Funding Risk* in case of inability to arrange the fund to maintain cash flow, *Time Risk* arises when performing assets turns into non-performing assets and *Call Risk* is when banks is not in position to take up the good operational activities when they arise to it[6].

Management: In order to limit liquidity risk bank adopts Cap on inter bank borrowing system. Board of directors have to prove strategies and significant polices in relation to management of risk and they should have information about liquidity position. Management structure and adequate information system has to be there for monitoring and controlling of liquidity risk. Procedure for ongoing funding requirement and effective internal control over liquidity risk management is to be there.

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[3] Organisation for Economic Co-operation and Development

[4] Thomas, H., Kevin F., Murdock, C. and Stiglitz, J. E., 2000. Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?, *American Economic Review*, Vol. 90 (1), pp. 147-165.

[5] Raghavan, R.S., 2003. Risk management in banks. *Chartered Accountant-New Delhi, Vol. 51*(8), pp.841-851.

[6] Mokal, R. J., 2015. *Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts*, Brook. J. Corp. Fin. & Com. L. 15, 96.

2. **Interest Rate Risk:**

It arises when due to change in rate of interest of bank, market value of equity is affected. It includes Gaps or Mismatch risk or *Yield Curve Risk* and *Basis Risk, Embedded Option Risk*, *Reinvested Risk* and *Net Interest Position* Risk.

Management: Under *BCBS Principle*[7]interest rate risk is measured from earning prospective and economic value prospective. From earning prospective impact is analysed from interest rate on accrual and reported earning in near time period. In economic prospective impact is analysed on expected cash flow. In order to control risk of interest board have to approve polices in relation to management of interest rate. Polices and strategies of bank in relation to interest rate are to be clear and it has to be ensure that they are consistent with complexities and nature of activities. Bank must have effective risk measurement, monitoring and control functions and the adequate information as well for above activities[8].

3. **Market Risk:**

It arises due to various moments that take place in market and it is generally in form of *Forex Risk* due to adverse rate of exchange in market and risk of *Market Liquidity* arises when bank is not able to conclude large transaction near to current market price.

Management: For managing market risk ALM framework[9] is used. Under these three pillars are set i.e. ALM Information System which includes management information system and information availability system, accuracy adequacy etc. ALM Organisation in which top management and structure and responsibilities are involved and ALM Process includes risk parameters, identification, measurement and management.

4. **Credit or Default Risk**:

Credit risk[10] arises when bank is unable to meet credit obligations as per agreement. It is generally found in form of *Counterparty Risk* which is connected with trading, *Country Risk* it arises when non-performance of borrower is result of various restrictions imposed in country.

Management: Effective risk management framework will comprise of:

- **Policy and Strategy:** Board of directors of bank have to review and approve credit risk strategy and polices on periodical basis. Approved document for credit risk policy is to be there with every bank which must include risk identification, measurement of risk, and

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[7] Reserve Bank India 2001, *Report of the Advisory Group on Banking Supervision*. Available at: https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=239. [Accessed on: 2 July 2019]

[8] Risk Minds Series 2016, *BCBS-239: The Burden Of A Principles-Based Regulation.* Available at: https://knect365.com/riskminds/article/483d489f-3ef8-4c2e-a32d-500395de343a/bcbs-239-the-burden-of-a-principles-based-regulation[Accessed on: 2 July 2019]

[9] Reserve Bank of India 2018, *Department of Banking Supervision.* Available at: https://www.rbi.org.in/scripts/AboutUsDisplay.aspx?pg=DeptOfBS.htm.[Accessed on: 2 July 2019]

[10] Bodla, B.S. and Verma, R., 2009. Credit risk management framework at banks in India. *The IUP Journal of Bank Management*, *8*(1), pp.47-72.

reporting and control techniques for risk, legal issues and management of the loan problems. Policy approved by board has to be communicated to branches of bank so that all officials of bank could understand approaches for sanctioning of credit and ensure accountability for following policy and procedures. Responsibility of credit risk polices will be on senior management of the bank.

- **Organisational Structure:** In sound structure the board of directors must have responsibility of management of risk. Risk management committee will be board level committee in which CEO, head of credit, operation and market committees will be there which will be working in coordination with each other. It will have to accept recommendation of committee and in case of denial rational for same is required and then served to internal and external auditors.
- **Operational System:** There must be effective credit risk administration, measurement and monitoring of process. Board should have consistent approach of recognising problems at early stage, classification of problems and remedial action for it. There must be continuous monitoring by board overall risk mechanism that has been adopted.

5. **Operational Risk:**

It occurs on internal failure of process, people and system of bank. It is of two types i.e. *Transaction Risk* like fraud, failure of business process etc. are main reason of this risk and *Compliance Risk* arises due to failure to comply with legal and regulatory formalities by bank.

Management: Operational risk can be measured by identification of risk event and analysing, assessing impact, treatment of risk and reporting. Risk management and compliance monitoring functions are to be carryout by line manager and has to develop basic standards for dealing with risk and then continuous assessment of same has to be carried out on his part.

Role of Regulators in Risk Management in Banking Sector:

Role of Reserve Bank of India: Grown complexities of banking due to deregulation and changes in behaviours of consumer resulted in ineffectiveness of control system. In order to deal with increasing level of risk RBI set guidelines to bank on risk management in 1999[11] under which banks are required to distribute the out flow and inflow in different maturity periods. Under this all liability figures outflows while assets inflows. These guidelines were updated in 2007 under which banks are allowed to adopt approaches of general nature in order to measure liquidity risk by splitting first time bucket i.e. 14 days, in statement of structural liquidity three-time buckets i.e. next days, 2-7 days and 8-14 days. Then assets of each bucket are assessed against liabilities. In case of mismatch of assets and liabilities that situation may turn into risk for the bank and on this stage, bank is required to take appropriate step for risk management. New mismatch must not during next day, 2-7 days, 8-14 days and 15-28 days' buckets must not be higher than 5%, 10%, 15% and 20% of cumulative cash outflow in set time period of buckets to recognise impact on liquidity.

[11] Reserve Bank of India Department of Banking Supervision Central Office, October 1999. Core Principles of Effective Banking Supervision.

Reserve Bank of India has put responsibility of management of risk on board of directors who are required to take active part in risk management policies and also in setting liquidity limits, foreign exchange rate, equity price risk and interest rate. Assets Liability Committee (ALCO) has been introduced by the RBI as top most committee to oversee implementation system by ALM system. It carries out function of considering product prices for advances and deposits, desire profile of maturity of incremental assets and liabilities along with monitoring level of risk in banks. It also carries out function of articulation of current rate of interest and to make it for decision making for future business strategies.

CAMLE Model[12]is also adopted in which there are six components namely Capital Adequacy, Asset Quality, Management, Liquidity and Earnings Quality which are focused for effective risk management in banking company. RBI realigned entire supervisory mechanism to Board of Financial Supervision. Supervisory and regulatory supervision of RBI has also been widened in which financial institutions as well as non-banking financial companies. Onsite supervision system is also developed in which assessment of core nature is carried on as per statutory mandate i.e., liquidity, solvency, management prudence and operational soundness. Due to recent trends of competition, financial integrations and globalisation one site supervisions is replaced by offsite supervisions by Board of financial institution so that risk can be identified at early stage. Offsite system involves asset quality, large credit and concentration, capital adequacy, earnings and risk exposures viz., currency, connected lending, liquidity and interest rate risks. Financial analysis of stock of bank in secondary market is useful source used for knowing financial performance of bank.

Basel Committee: It is a primary global standard settler for regulation of banks on supervisory matters and it has issues guidelines on the basis of OCED Principles[13] for effective corporate governance in banks. Basel Committee on Banking Supervision[14] is focused towards making banks more sensitive towards risk since most important reason of risk are breakdown of internal control and corporate governance. Committee has identified major breakdown like lack of control culture by management, inadequate risk assessment of certain banking activities, lack of communication between different levels of management and inadequate monitoring and audit programme. Use of internal system is allowed in order to measure risk and thereby allocating capital accordingly. Three pillars are developed with a view to maintain financial stability in banks. These include Minimum capital requirements, supervisory review process and market discipline. Under pillar of supervisory review process necessity of exercise of internal assessment is recognised in order to ensure that the management is exercising the strong judgment and has kept the capital for various identified risk in advance. Board has been entrusted with responsibility of business strategies and financial soundness and they must in

[12] Grade Up 2018, *Risk Management in Indian Banking Sector and the role of RBI.* Available at: https://gradeup.co/risk-management-in-Indian-banking-sector-role-of-RBI-i-257b7efc-8ddc-11e5-9323-7aed798fd5ce. [Accessed on: 2 July 2019]

[13] OECD, 2014. Improving Corporate Governance in India: Related Party Transactions and Minority Shareholder Protection, Corporate Governance, *OECD Publishing*.

[14] Basel Committee on Banking Supervision 2012. Core Principles for Effective Banking Supervision. *Bank for International settlements.*

exercise of these responsibilities have to adopt duty of care and diligence. They must be engaged in actively in affairs of bank and must monitor implementation of risk measures effectively. Board must also set up good corporate culture by setting corporate values and by promoting the risk awareness in a strong risk culture. Board should ensure that professional codes of conduct are duly followed.

Analysis of Existing Regulatory Framework

Role of RBI is indispensable in current risk management of banking institutions in India. It is true that risk cannot be eliminated from banking activities but same can be eliminated and for effective elimination of risk in banking institution RBI has introduced various regulations which apply to both public and private banks equally. With help of RBI only entire Indian banking system is professionally managed and proper risk management are adopted at individual banks levels. Above discussed regulations of Basel and its committee's role of board of directors have been explained clearly and they are put in centre of governance of banking system. There are various models that have been suggested for effective management of credit risk in bank like "*Internal Rating Based*" in which focus is to be drawn on various factors that causes threat of risk in banking system. So present in built risk control system are equally strong for both private sector banks and public sector banks. Role of Basel Accord is also very significant in making risk management of banking institution effective and thereby assisting in effective corporate governance system.

Recommendations and Conclusion

Risk is indispensable in banking sector and timely and proper assessment of risk can only be helpful in making effective risk avoidance decisions by board. Board is using magnitude of risk and thereby making strategies for good corporate governance in banks. Acceptance of Basel Accord II by the RBI is a move towards more effective risk management since it is focused on enhancing risk sensitivity of capital requirement, promoting coverage of comprehensive risk and more flexible approach by board members. Board must follow consistently various principles that are stated there in Basel to bring good corporate culture in bank and mitigating risk in effective and efficient manner.

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