RISK PROFILING AND GENERATION OF SOLUTIONS IN BANKS

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ABSTRACT

Risk profiling is a more elaborate task. It involves working on the risk return profiles based on probability of occurrence and impact it will have on the organisation.

Generation of solutions Based on risk profiling, solutions are generated. The solutions may be:-

1) Risk Avoidance
2) Risk Transfer
3) Risk Acceptance

Monitoring and updating

Monitoring and updating are continuous processes. Once again, when the factors affecting the risk profile of an organisation are identified and well communicated internally, the process of monitoring becomes a very smooth task. A well oiled machinery of information flows and reporting, which is the responsibility of the top management, is critical to the task.

Key words: *profiling, solutions, generated, responsibility. Profiling*

INTRODUCTION

India's financial system is broadly serviced by two major groups: banks and financial institutions. India's scheduled commercial banks remain the major depository institutions and mobilize most of the country's savings. In the absence of a developed domestic long-term debt market, financial institutions maintain their specialist role in meeting the long-term funding requirements of large and midsized corporates.

The Indian banking system can be broadly categorized into public-sector banks, private banks, and specialized banking institutions. While the Indian banking system has been the subject of continuous liberalization to varying degrees since 1991, it remains tightly regulated by international standards. Outside of the nationalized institutions, the majority of banks operating in the system are of modest size in an international context, and their operations are highly concentrated in regional or rural centers. Following deregulation and the relaxation of barriers to entry in the industry, a number of new players are emerging, and larger entities are becoming more diversified. Although the new entrants have been able to capitalize on poor customer- service levels and inefficiency that has previously characterized the public-sector banks, some of the public-sector banks have embarked on various initiatives to counter such competition and regain the advantage.

Apart from the nationalized banks, the Indian finance system has a number of players, including term lenders, investment institutions, and nonbank finance companies. The commercial banking sector is, however, dominant, representing more than 74% of total financial system assets at March 31, 2006. Nonbank financial institutions made up the balance, of which 8.6% were term- lending institutions and 15.4% investment institutions. The proportion of commercial-banking- sector financing assets is expected to increase further at March 2009, however, with the conversion of a development financial institution, IDBI, into a commercial bank.

REVIEW OF LITERATURE

Since 2002 the RBI has implemented several measures that further strengthened the processes for the resolution of nonperforming assets in the banking system. One such change in legislation was the SARFAESI Act, creating stronger foreclosure powers of banks and financial institutions, enabling them to foreclose and sell underlying assets without court intervention. Under the Act, guidelines are set for the formation and functioning of securitization companies and reconstruction companies. As a result of the Act, the Asset Reconstruction Company of India Ltd. (ARCIL) was set up, and banks and other financial institutions transferred to ARCIL nonperforming assets with total dues worth about Re165 billion ($3.75 billion) at June 2005.

The Corporate Debt Restructuring (CDR) system in India became effective in March 2002, to provide a framework for ensuring a timely and transparent mechanism for the restructuring of corporate debt for viable entities outside the purview of the Board for Industrial Financial Reconstruction (BIFR), debt-recovery tribunals, and other legal proceedings. The CDR system operates under a three-tier structure, consisting of the:

- CDR Standing Forum and its Core Group — the policy-making body;
- CDR Empowered Group — the functional group deciding on the restructuring casesreferred to the CDR mechanism; and
- CDR Cell — the secretariat to the CDR system.

Further revisions to the guidelines were made in February 2003, some of which included:

- Segmenting of restructuring under the CDR system into two types, whereby assets under the 'Standard' and 'Substandard' categories would be restructured under Category I, and assets under the 'Doubtful' category would be restructured under Category II.
- Eligibility to include suit-filed cases provided the proposal to restructure is supported by at least 75% of the lenders by value.

- Eligibility of large BIFR cases to be decided by the CDR Core Group.
- Discretion to join the CDR system on a case-by-case basis for investment institutions and foreign lenders that have provided finance from outside the country.

The SARFAESI Act is expected to remain an effective tool in compelling defaulters— particularly willful ones—to settlement, while strengthening banks' foreclosure powers. The sale of problem assets to asset-reconstruction companies (ARCs) also provides Indian banks with an additional window to clean up their balance sheets. This avenue allows banks to transfer their nonperforming assets at a mutually agreed discount to the ARCs.

MATERIAL AND METHOD

Risk profiling is a more elaborate task. It involves working on the risk return profiles based on probability of occurrence and impact it will have on the organisation.

Generation of solutions
Based on risk profiling, solutions are generated. The solutions may be:-

- Risk Avoidance
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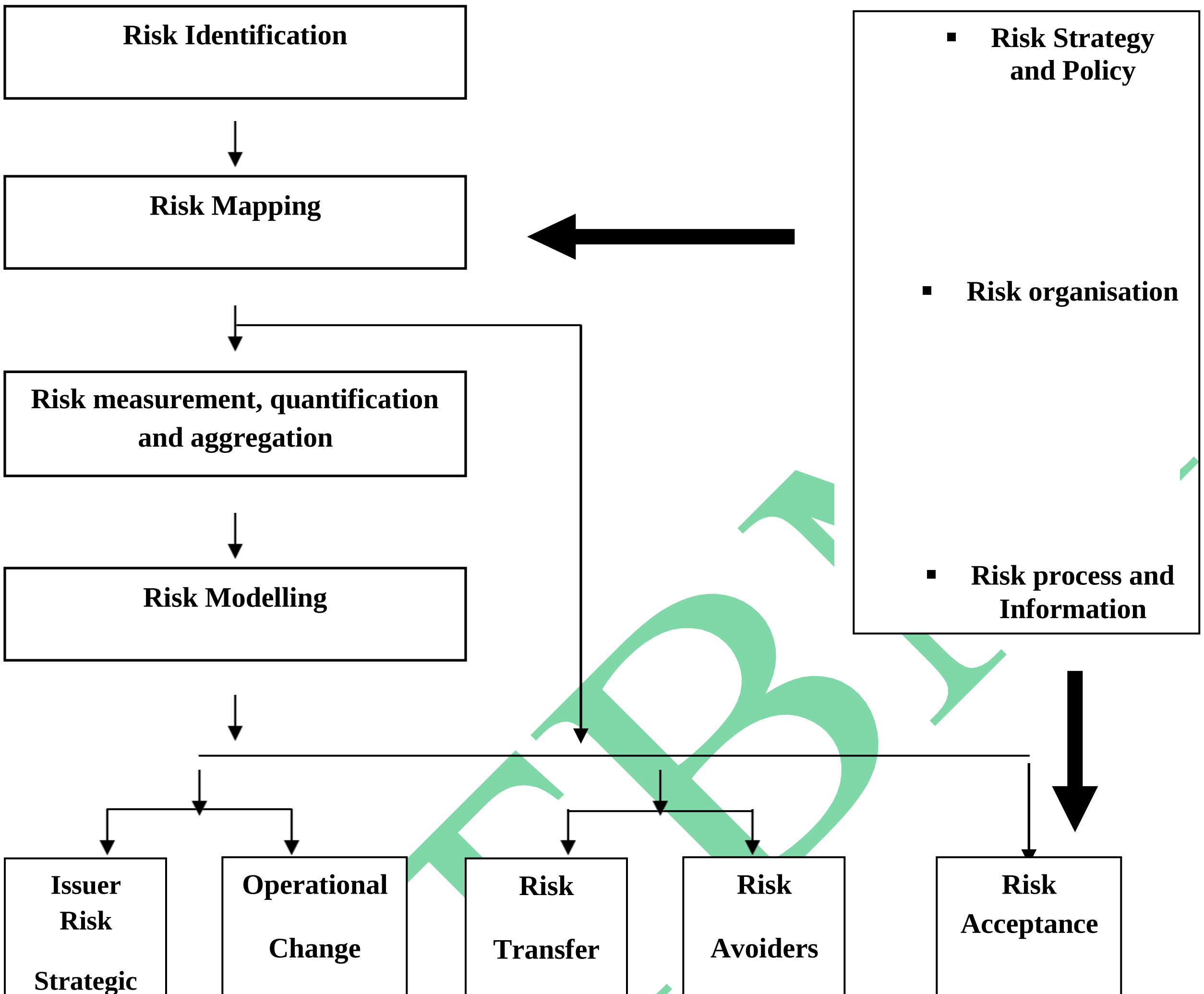
Monitoring and updating
Monitoring and updating are continuous processes. Once again, when the factors affecting therisk profile of an organisation are identified and well communicated internally, the process of monitoring becomes a very smooth task. A well oiled machinery of information flows and reporting, which is the responsibility of the top management, is critical to the task.



The process of Risk Management

Please refer to the supplement under this framework for the management of market, credit and operational risk We now proceed on to understand one of the key regulatory issues addressing the concept of risk ad risk management- the Basel II accord BASEL II Accord: The structure The Basel II comprises of three mutually reinforcing pillars meant to contribute to the safety andsoundness of the financial system:

- First pillar: Minimum capital requirement
- Second pillar: supervisory review process
- Third pillar: Market discipline

The first pillar: Minimum capital requirement

This sets out a minimum capital requirement of 8% of capital to risk weighted assets, and incorporates improvements in the calculation of capital adequacy:

Total capital (unchanged)/ credit + market + operational risk = Bank capital ratio (minimum 8%)

Basel II also provides a menu of approaches for measuring credit risk, market risk, and operational risk.

A menu of approaches to measure

Credit risk	Market risk	Operational risk
Standardised approach (modified version of the existing approach)	Standardised approach	Internal models approach
Foundation internal rating based approach	Internal models approach	Standardised approach
Advanced internal rating based approach		Internal measurement approach

Basel II Approaches

CONCLUSION

Under this approach the bank assigns a risk weights to each of its assets and off-balance sheet positions and produces a sum of risk weighted assets values. The risk weights are to be redefined by reference to a rating (provided by a rating agency) that meets strict standards.

The internal rating based approach
Here, the bank estimates each borrower's creditworthiness and estimates the *potential future loss amount* to calculate the minimum capital requirement. As a greater range of risk weights are employed, this approach is more risk sensitive.

This frame work allows for both a foundation method and more advanced methodologies. While in the foundation methodologies, banks estimates the probability of default associated with each borrower and the supervisors will supply the other inputs, in the advanced methodology, a bank with a sufficiently developed internal capital allocation process is permitted to supply other necessary inputs as well.

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