

RISK MANAGEMENT IN BANKS: A DESCRIPTIVE STUDY

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***Abstract.** Banking, though integral part of an economy, is the most volatile business because of the commodity it deals in changes value with variation in its circulation. Money value in the market, at times, is determined by its quantity, but the number of transactions carried out with money is of equal importance. Rarely, it happens that the quantity alone affects its purchasing power. The value of money is thus a function of both the supply and demand which together determines the trend of prices in the market. The supply of money results from the credit decision of banking industry as a whole which generally takes into account the market scenario depicting future economic activities and safety of banks funds. No doubt the scope of market mostly depends upon the availability of finances yet the market stability ultimately helps in credit expansion by promoting optimism and growth opportunities in the economy. This paper will discuss the various elements of risks which render the money market more volatile and will suggest preventive measure to minimize the chances of Loss so that the flow of credit may continue unhindered.*

Key words: Bank, finance, economy, risks, business, safety, assets, risk mitigation

Introduction

Risk is a concept widely used in matters associated with the assets and liability management. The term denotes a phenomenon where in danger of loss in the value of assets is apprehended or there is an apprehension that a substantial addition to the liability may arise due to the happening of a presumed event. It is potential danger of loss associated with the happening of particular event. It is a contingent loss which may or may not arise.

According to Khan Risk is a probable loss in income or assets. He further elaborated his views and said that it is unexpected loss which comes in the definition of Risk and the expected loss is not included. Nevertheless it needs to be guarded against. The term is normally used for the losses which arise during the course of business due to imprudent management. To mitigate the repercussion or eliminate the chances of occurrences, the shrewd managers use various instruments and technique to minimize the quantum of loss although danger cannot be eliminated altogether. The practices and use of such

techniques which minimize the chances of loss in the value of an asset or additional impact of liability is in fact the management of risk. In banking both the assets and liabilities aspects are equally important to be taken care of. The banking business largely depends upon the volume of deposits secured and any such event which may result in the loss of deposits, may it be with drawl by the customers due to declining trust or quality of service may attract initiate attention of the managers. Under such circumstances the managers are always anxious not only to retain the exiting portfolio but also make all out efforts to increase the deposits. This is because the ever increasing deposits give strength to the management to increase and enlarge its investing and leading post folio and there by generate maximum revenue to add to its profitability. Profit is no doubt the major goal of bank yet it can be increased only by disbursing quality finances and keenly caring of its investment portfolio. The curiosity of manager in selecting customers with integrity and worth is an artful job and demands extra skills to predict and identify the risks associated with a particular post folio and prevent the occurrence of the contingent event which may possibly cause a loss to the institution.

Calvin (1994) emphasized upon the effectiveness and efficiency of the organizational unit. He was of the view that an efficient organization achieves its purpose with minimum waste of resources. He further said that effectiveness and efficiency are co-related and are both necessary for long term success.

The risk management, therefore, warrants in time identification of various types of the risk involved in the transaction of the business and also take preventive measures to mitigate the loss.

Methodology

It will be a descriptive study. In order to ensure safe disbursement and timely repayment of bank's finances an extensive study of the various elements causing the loss in the value of bank's finances either due to classification or through delayed payment will be found. Besides advances portfolio bank's money is lost due robbery, fraud, forgery, and embezzlement. The study will mainly focus on cause of the losses to banks and will eventually find the alternatives to prevent the occurrence of events which lead to losses. These causes will be analyzed for suggesting preventive measures. Secondary data available in the market will be utilized and also a case study of a local bank be made for academic purpose.

Risks in Banking Business

Banks as custodian of public money on one hand play a significant role in determining the direction of the national economy and on the other hand are charged with the responsibility of safeguarding the interest of the stakeholders.

As fund supplier, they move the economy towards growth and satiability. However, the organizational goal of bank can be achieved only when money lent is recovered in time and without incurring additional expenses. Such institution is in fact an ideal for the stake holders which ensures growth and promotes the interests of all the stakeholders. Therefore, operational mechanism is so designed and procedure so carefully implemented that least chances of loss are left uncovered. So every risk is properly analyzed and preventive suggestions are made to avoid occurrence of any event which may cause any loss to the institution.

Since banking business mainly revolves around money, therefore, its sensitivity and intricacies requires extra vigilances to ensure the smooth flow of credit besides optimal utilization of other resources. For academic purpose there are numerous risks which needs attention but the risk involved in credit both pre and after disbursement has since attained paramount importance. The identification of risks helps in managing them through affective measures. But in some cases where the happening of events becomes beyond the jurisdiction of management, then alternative arrangements are made with the help of insurance companies. The most commonly known risks encountered by banker among others are as follows.

- (1) **Poor Information Risk.** The pre sanction/ disbursement risks take their origin from the selection of borrower. It is commonly observed that the infected port folio of the bank comprises on loan accounts owned by sponsors of high worth with regular income flow. The default has never been due to non availability of funds with the borrowers, rather it is always due to the weak will to pay back the banks dues. Although will to pay is a psychological phenomenon, yet the past track record and market reputation of the prospective borrowers helps in determining the integrity and credit worthiness. In fact an intensive and extensive inquiry on the borrowers before initiating a loan proposal saves the money from loss. State Bank while introducing the KYC mechanism has provided guide lines in obtaining information on the genuineness or other wise of the borrowing applicant at the very initial stage. Although in some cases social pressure forced the defaulters to arrange repayment of the classified advances yet the common proverb“Nip the Evil in the Bud” will save the bank from cumbersome recovery process or expensive litigation. It is,

therefore, imperative that in the matter of lending decisions the inherent risk in the loan proposals may be identified and preventive measure be taken prior too taking a final decision of loan disbursement.

- (2) The income generating capacity of the business entity for which the loan is being asked for needs to be considered to because the incapability of the business renders the borrower incapable to liquidate the liability within a specified time period which phenomena will ultimately put the credit at risk. It is because of these reasons that poor income generating capacity leaves nothing to pay back the original loan amount what to talk about the interest and mark up and eventually adds to the liabilities of the defaulting borrower. In case of newly established business concerns the financing manager has to take into consideration the market and the business trend of the products being produced because in case of non disposal the stock will continue accumulating and will ultimately put the bank money at risk. The elasticity of demand for such products sends a signal of warning to the lending agency due to the availability of substitutes or increase in supply in the market may place the borrowing entity as a weaker competitor. Also an infant business entity takes time to establish its integrity and worth in the market.

Political Risk

Political instability in the country results in frequent change of charge which eventually affects the policies relating to trade and industry. Policy variations directly affect the growth process, ultimate impact of which falls on the creditors. The business activities suffer due to uncertainty. This leads to a declining trend in over all businesses and cause a fall in the income generating capacity of the borrowing entities. With little amount of liquid assets the repaying capacity of the debtors falls adding to the frequency of default. In many cases sabotage activities resulted in destruction of valuable assets and industries in the region lost its core capital paralyzing the industrial growth process.

A failure of one unit generally sends shock throughout the economy and banking, the more volatile industry, suffers comparatively more than any other sector/industry.

The nationalization policy of late Zulfikar Ali Bhutto in Pakistan in early 70's set a severe setback to industrial growth in the private sector because no entrepreneur was ready to undertake risk loss of factory unit which might be the result of subsequent taking over by the state. Hesitation of by the industrialist on the one hand and poor management of taken over industries on the other hand

retarded the growth process. As a result of declining trend in the production the money borrowed from banks went in default. On the other hand since establishment of new units carried the danger of nationalization the demand for credit fell and surplus funds with banks could not be properly deployed and caused a fast decline in the revenue of the banks. A change in policy relating to Industrial estates in Hattar and Gadoon was major cause of closure of most of the units which created a serious problem for banks in recovering their finance.

Country Risk

Cross the border internal disturbances due to political unrest invariably affect the trade and business activities in the neighboring countries which directly change the business scenario. This change, besides other, reduces the income generating capacity within a country and thus poses a risk to the assets of bank troubled relations with such countries carry a great risk of loss of business. Barring imports or restricting exports by these countries retard international trade process occasionally resulting in closure of the units running on the imports of raw materials from neighboring states with strained diplomatic relations. Trade restriction between countries equally adversely affect the export business which in turn disturbs the balance sheets of the exporting industries and finally result in decreasing and many a times no repaying capacity. The rift eventually leads to pressure on the units carrying their business on bank credit because of income loss causing liquidity problems. Such a situation generally affects the entire banking sector because of its more sensitivity.

Loss of trade between Pakistan and India since 1965 war deprived both countries benefitting from the results of the innovative efforts and loss of revenue.

Location Risk

Business or industry location plays an important role in the standing of the business entity. Unauthorized establishments or remote areas without infrastructure facilities have led to the collapse of the business. The non availability of social security, continued disruption in the power supply, non availability of skilled labor, difficult accessibility of raw material and market cause a deadlock in the business and loss of revenue. As an example of business established in the residential areas of University Town and Hayatabad, Peshawar which have been sealed under the order of Peshawar High Court. The restricted supply of Mulla Gori Marble was one of the major causes of failure of big marble industrial units in K.P.K. The failure of K.P.K flour mills was absolutely due to non availability of wheat from Punjab. The closure of such

units affected the operation of credit giving institutions and banks which had to restructure or reschedule their dues against such units.

Environmental Risk

Depending on the nature of business, environment impacts the success or otherwise of the business. Extreme hot weather conditions have caused failure of poultry business. At times the existence of industries is found injurious to the public health due to environmental pollution. Under such circumstances the regulatory authorities at any time resort to cleansing operation consequences of which directly hit the repaying capacity of the business entity. Plant diseases in the locality cause a severe failure of crops and under such circumstances not only the Agriculture sector loses its capacity but all the Agro- based industries in the area face a worst situation while liquidating their liabilities. Hilly tracks adjacent to volcanoes have always been in a risk trap. An abnormal snow fall in the high altitude areas cause failure of crops and delayed transportation. Credit dealing with such industries carried greater risk of physical destruction of the industrial units and other structures built with help of bank's finances due to natural hazards.

Socio-cultural Risk

Socio cultural values play an effective role in the promotion of business. No doubt strong publicity has induced a major part of the consumer community to adapt to the changing market supply which includes fashion and style yet in some societies, religious and social values still hold strong grip. Industrial units if propagated against producing Haram/Non permissible consumer goods will fail to dispose off their stock and thus unable to off load their loan amount. Conservative communities specifically adhere to their customs and traditions which usually affect aggregate effective demand. An abrupt decline which sometimes occurs due to prejudice and boycott curtails sale and reduces the revenue generating capacity. The lenders in such a situation cannot recover the loan amount due to liquidity problems with borrowers.

A very important aspect of these phenomena is common hesitation of the majority of the population transacting with because of its non permissibility under the law of Islamic Jurisprudence which is in fact part of the socio cultural values of the Muslim Ummah.

Natural Disasters Risk

Areas normally relying on weather and mercy of Nature are more expose to events like famine and flood. Nature is beyond the jurisdiction of human being. An earth quake, epidemic, famine, or any catastrophic mishap turns good businesses into collapsing entities. Such businesses shocked by nature phenomenon lose their worth due to financial hardship and face difficulty in discharging their liabilities in time. The situation is worst from the repaying point of view of the borrowers when the business has been established or running with the help of borrowed money because it directly hits the lending institutions like banks.

Organizational Risk

Organizational hierarchy is responsible for putting right policies in place at right times and also keep close watch over business trends so that immediate measures are suggested to cope with changing situations. The Board of Directors are required to keep themselves abreast with the business environment so that each lucrative opportunity is in time tapped. While lending or financing a project the creditor has to keep into account the quality of management of the organization being financed. At times the collateral had priority \and it was presumed that security protects the lender/financier from any inability of the borrower. , but the concept has now gone a radical change. The bankers does not stand to earn for one time rather banking business is a continuous process which succeeds with a success of entire commerce and industrial sector. The academic back ground, experience and managerial skill of the sponsors/ stake holders help the middle management in properly handling every critical situation. Policy formulation and implementation both are equally important in the matter of organizational success. Intelligent and bold decisions are necessary and pre-requisites for availing the market opportunity. The poor organizational hierarchy with incompetence carries a great risks of loss and so a loss to the financing institution. Weak administrative control leaves loopholes for mismanagement. A lack of strict vigilance and close supervision has always resulted in misuse of power and authority.

Habib (2014) taking the failure story of Baring Brothers and Company of England observed that it originated from the unbridled powers vested in its young executive Nick Leeson posted as General Manager in Singapore who used to deal in Futures and Options. Although in the year 1994 Nick Leeson could book unexpected false profit of GBP 28.5 (M), yet none of the senior executives in the company ever took notice of the fictitious account No. 88888 operated by Nick Leeson to hide losses which ultimately cause collapse of the Baring Bank. The management's professional competence and acumen could

detect the abnormal transactions and also the hazards involved in the dealing of swap, futures and options.

Maciariello (1984) while discussing environmental scanning observed that “Top management is generally responsible for activities leading to the formulation of goals and objectives, strategies, policies for the acquisition of resources and allocation of resources for the company’s “portfolio” of businesses”.

Lehman brothers of USA unscrupulously continued disbursing mortgage financing without taking care of the repaying capacity of the borrowers and also the market if the housing industry. The borrowers could not meet their commitments and the bank failed to overcome the liquidity problem. The Central Bank did not support the Lehman Brothers Bank which fell in need. The failure of this bank sent shock through out the financial system. Because one of the reasons of financial crisis not only the American Economy suffered but it caused a global depression.

Credit Risks

According to Patial –Abera (2014) Credit Risk is the probability that some of bank’s assets specially its loans will decline in value and possibly become worthless.

However the concept covers a variety of variables which affect the value of assets or for that the quantum of liabilities. The safe lending decisions are accordingly affected by more than one factor to minimize the risks involved in credit approval /disbursement. The following risks endanger the profitability of the bank.

(a) Equity Risk

It is common experience that flourishing business attracts new clientele. Growth of business is the urge of every entrepreneur but in case the banks continue lending imprudently without taking in to account the statutory restrictions there is every possibility of violating the law of the land which may attract severe penalties from the regulatory authorities putting the bank in hard water. The lending/financing by banks must be in proportion to the net equity as per laid down rules of business. This issue has clearly been resolved by the State Bank of Pakistan promulgating Prudential Regulations wherein exposure limits have been defined both for the banks as financier and the client as borrower. The Debt equity ratio both for Bank and client prescribed in the Regulation must be observed if a bank desires to be on safe side. It, therefore, necessitates an increase in the paid up capital before increasing the total lending. Disproportionate lending puts the bank’s corporate image at stake because of

contingent run on bank. Alternately the outstanding finances are to be reduced to bring them to reasonable level. The quantum of core capital and also the available reserves play a significant role in the determination of lending capacity of a Bank. The Assets /Liabilities Committees normally known ALCO formed in banks are primarily charged with the responsibility of ensuring maintenance of statutory ratios between the assets and liabilities of the lending bank of which most important is adequacy of core capital. Any deficiency in the equity poses the institution to very unhealthy situation and if not checked in time attracts regulatory action which may result in ban on lending/ financing. Such a phenomenon directly impacts the market reputation of the bank besides financial penalty.

(b) Market Risk

No doubts banks deal in money yet the funds collected from various depositors are in turn financed to the business and industrial community. The borrowers of the bank money in their way invest in different business ventures to produce and distribute goods and services in the market. The success of the borrowers is, in fact, the building of revenues generating capacity. This characteristic can be attained only when the borrowers are able to dispose of their product in the market. In other words the market demand for goods and services of the borrowers determines the demand for funds and repaying capacity of the borrowers. Future demand for a particular product determines the eligibility of the borrower for finance. Ever changing fashion trend and technological innovation invariably affect the existing tempo trade and status of machinery. A change in demand for and supply of a particular product changes the revenue generating capacity of the borrower and so a change in the repaying capacity. Introduction of substitutes is one of the main reasons of which exposes bank's finance to a greater risk of default. Borrowing entities dealing in stock, securities and goods with more fluctuating market trends carry heavy default risk. Illegal import of substitutes often carry dumping phenomena with it directly adversely affects the local demand resulting in reduced sales and poor debt servicing. The 80's decade and even afterwards the electronic and synthetics textile industries in Pakistan suffered huge losses due to a flood of Russian and Japanese products which wiped off very established industries due to cut throat competition. Prudent banker takes notice of future business trends and changes financing policies accordingly.

(c) Business Risk

The business trends of the borrowing entity directly affect the collection rate of the financing institution. The borrowers depending on single supplier or a particular market may face difficulty the moment the supplier fails / refuses to supply or the market being depended upon by the borrower fails to absorb the quantity or refuse to accept the goods being produced by the borrowing entity. Under such circumstances the revenue generating capacity of the borrower declines and so the repaying capacity of borrowing client falls creating a severe problem for the lending bank to recover. Borrower's market share and marketing strategy is of much significance because only those entities succeed in the market which can face the competition and this is possible only when the firm or company foresees market trends and shape its policies accordingly.

Armour (2014) was of the view that the risk of potential competitors and managing for it in advance adds to the strength of the firm to sustain any pressure from the cut throat competition.

(d) Collateral Risk

Customarily banker mitigates risk of borrower's default by making an effort to reduce the losses occurring due to poor or non debt servicing by the borrowers and gets its debt assets secured through obtaining either actual or constructive possession of various tangible marketable assets/commodities in addition to the personal surety. At times Central Bank had prescribed marginal requirements against various items under selective credit control system which aimed at exercising extra caution while extending finance facility. This very requirement emphasized the sufficiency of the quantity which can cover the finance amount in spite of price variation. Still inherent danger of decrease in the value of such securities due to deterioration in the quality of the security or declining trend of market prices puts the bank's assets at stake. Securities pledged with bank are often meant to avail the price margin. A sudden fall in the prices of stock pledged/hypothecated renders the borrower unable to meet his/her commitment. The securities rarely saleable lose their market when put to auction. Immoveable property in the hard areas or for that matter borrowers with strong political influence are difficult to be persuaded to repay in case of default and so is difficult to recover outstanding amount out of the securities placed with bank.

(e) Documentation Risk

Every security offered against a finance facility is valid only if it is genuinely placed with bank for the purpose of ensuring timely repayment of the finance amount. In case of default the banker resorts to securities for appropriation of the sale price towards the adjustment of the bad debt. The banker derives this

right of appropriation from the document evidencing the authority reposed in banker by the borrower in the form of letter of pledge/ mortgage/lien/ earmarking.

However the right still seeks its justification when the borrower is either him/herself is the owner or holds valid authority of by the owner to so offer the security.

A title subsequently found fake or defective cannot pass on a good title to the transferee. Thus the document is void and invalid. Documents later on found fake signed under impersonation, beyond jurisdiction, unauthorized or with defective title does not entitle the bank to recover the amount. Similarly expired documents deprive the banker from right of foreclosure and hence the risk of loss of the asset.

It, therefore, necessitate that proper standard be set for various measures and steps to check and scrutinize the transactional instruments for ensuring the criteria compliance.

Anthony M. Santomero (1997) while discussing the implication of various risks in Commercial Banks found that “The first of these risk management techniques involves two different conceptual activities, i.e.,

- i. Standard setting and Financial reporting. They are listed together because they are the sine qua non of any risk system. Underwriting standards, risk categorizations, and standards of review are all traditional tools of risk management and control.
- ii. Consistent evaluation and rating of exposures of various types are essential to understand the risks in the portfolio, and the extent to which these risks must be mitigated or absorbed.”

(f) Moral hazards

(i) Human Resources Risk: Banks while dealing in money are confronting a number of problems due to undesirable human behavior. During the course of business bank loses its assets due to frauds, forgeries and embezzlement. Also money is lost due to default by the borrowers only because of sheer negligence, inefficiency and connivance of the officials at the helm of affairs. The men assigned with the responsibility of safeguarding the interest of the bank indulge in professional malpractices and the public money is placed into the wrong hands. Criminal involvement of bank employees is a serious problem confronted by banking institutions. Lack of skill and professionalism makes the bank employees fall prey to the fraudulent elements of the society. Professional development, strict vigilance through both regular and surprise audit/inspection

and effective punishment/reward system mitigates this particular risk which entails defamation of the institution besides financial loss.

(ii) Personal Risk: Moral hazards is serious risk. Repaying capacity of the borrower is closely associated with his/her *will to repay*. This is a psychological phenomena and is subject to many factors other than the financial worth and income of the borrower. Capacity to pay can be measured by working the value of the assets and also the sources of revenue but the Will to Repay cannot be determined in terms of money. It is commonly observed that big business men of political and social influence with sufficient resources evade debt servicing till last moment to get remission and waiver of .The existing resources have been found diverted to other venues and loan/finance amount is left to pile up.

A detail enquiry in to the personal character, social status and integrity of the borrower in the market and goodwill of the business entity helps in making credit decisions.

Technological Risk

The ever expanding scope of modern technology has no doubt facilitated accounting procedure and client service but in the absence of skilled work force it carries more risk of wrong payments and fraudulent withdrawal. To ensure safe operation, training needs assessment, proper training and development of the employees will improve upon the efficiency of human resources. However, strict vigilance can only minimize the risk of loss due to moral hazards.

Basel committee on Banking Supervision provides guidelines for secure operation at all level worldwide. In its report of June 2014 the committee observed that a Transparent operating procedure reduces the risk because least interference of political elements and legal and accounting frame work. Her supervisory role of the middle management attains more significance.

Timely detection of irregularities prevents any fraudulent act provided the early identification is ensured through regular Monitoring and proper reporting of financial transaction. This requires on-site examination, close liaison with audit and inspection team members and management of the bank. With the deployment and use of Information technology i.e., introduction of E-banking the need of developing skill of the employees is urgently felt.

The role of Policy makers of which the Board of Directors attains the most significance influence is more decisive. The Basel Committee Report disclosed that “it is incumbent upon the Boards of Directors and banks' senior management to take steps to ensure that their institutions have reviewed and

modified where necessary their existing risk management policies and processes to cover their current or planned e-banking activities”.

Financial Risks

Return (Interest) Rate risk: In fact the banking industry is run on the basis of surplus funds collected from public as well as private sector. A continuous flow of these funds is linked with incentives to the fund holders so that they may continue saving a part of their income for further injection in the economy. This incentive is generated by the banks by investing the deposits and earning thereon by way of interest which is sometime called Mark-up.

This rate of return or for that matter Interest is more vulnerable to market changes and is, therefore, volatile. A small downward movement disturbs the whole financial statement of a bank. It thus carries heavy weight on the overall financial performance.

Lending rate once agreed continues till the expiry of the validity of the facility but the Market rate varies with a change in the monetary policy besides the changes in the market trends. A sudden upward change in the interest rate payable to depositor adversely affects the earning of the bank because net interest income falls on account of increased or interest expense. The bank must, therefore, be capable enough to absorb such a shock without much disturbing the balance sheet. The significance of bank rate in cannot be overemphasized in evaluating the impact of interest rate. To counter such an eventuality the bank evaluates the vulnerability of the income portfolio and adjusts to the fluctuation in the interest rate

As a primary measure, a duration gap, which the time period of market value of the asset to a percentage changes in the market interest rate, is found. By working out the average duration gap which arrives at by finding out the difference between the average time period of bank's assets and average time period of bank's liabilities. The bank can manage the risk of interest rate fluctuation by narrowing the duration gap. The risk can be minimized if not eliminated altogether.

The Gap arises because assets and liabilities are held against different amounts of loans with different maturity dates or renewal with different rates and dates which allows exposures to unanticipated changes in the interest rate prevalent in the market.

Interest Rate risk: from its economic value perspective emerges out of the difference between cash inflow on assets and cash out flow on liabilities plus net

cash flow on off balance sheet items. This perspective tells about long term interest rate gap.

Anthony (1997) in his essay on Commercial Bank Risk Management: an Analysis of the Process disclosed that some of the risks can be transferred and thus the risk of the transferring bank can be mitigated. Explaining his point of view he says that

“There are also some risks that can be eliminated, or at least substantially reduced through the technique of risk transfer. Interest rate risk can be transferred by interest rate products such as Swaps or other Derivatives. Borrowing terms can be altered to effect a change in their duration. Finally, the bank can buy or sell financial claims to diversify or concentrate the risks that result from servicing its client base.

However, there are two classes of assets or activities where the risk inherent in the activity must and should be absorbed at the bank level. In these cases, good reasons exist for using firm resources to manage bank level risk. The first of these includes financial assets or activities where the nature of the embedded risk may be complex and difficult to communicate to third parties. This is the case when the bank holds complex and proprietary assets that have thin, if not non-existent, secondary markets. The second case included proprietary positions that are accepted because of their risks, and their expected return. Here, risk positions that are central to the bank's business purposes are absorbed because they are the *raison d'etre* of the firm. In all such circumstances, risk is absorbed and needs to be monitored and managed efficiently by the institution. Only then will the firm systematically achieve its financial performance goal.”

Risk Identification-Warning Signals

A shrewd banker keeps himself posted with the business trend and the business status of the borrower and notes the negative changes for in time remedial rather preventive measures. Foresightedness of the bank manager helps him to make timely decision for safeguarding the interest of the institution by withdrawing the financing facility not only from the particular customer but also review his decisions about the prospective clients engaged in the affected industry. Although the monitoring the finance commences after the disbursement of the finance/loan amount yet a minor mistake during the processing of finance proposal or even at the time of disbursement may unexpectedly result in an irretrievable loss. Strict vigilance and close monitoring can, however, check the

situation from further deterioration. Therefore, as prudent banker the manager must focus on the following aspect which guide in diagnosing the health of the borrowing unit.

1. Examining the comments in the periodical inspection and audit reports on borrower's account and collateral. The report will guide in continuing the business dealing with borrower.
2. Obtaining information on the business trends and status of the borrower from the external sources using the business contacts which will help in verifying the market reputation.
3. Surprise re-evaluation of the stock and other securities held by the bank will disclose the factual position of the business.
4. Weak turn over in the inventory and stock of the borrower tells that the borrower has lost the market and is unable dispose off the existing stock.
5. Increasing receivable and also payable account of the borrower with average period of signals warning that the borrowers can not liquidate the liabilities due poor cash flow. Also it indicates that with minimum sales the borrower is constrained to sell out on longer credit which unhealthy symptom.
6. The perusal of balance sheet will reveal the current assets and liabilities ratios and hence the liquidity position of the borrower.

Yield Curve Risk arises as result of earning of an asset which is depicted in the form of movement in the yield curve. It tells impact on the values of various investments and their affect on income.

Embedded Option Risk: Since the borrower has the option to repay the amount before the expiry date and similarly the depositor can withdraw the amount from the account or encash the fixed deposit at any moment before the maturity date, the eventuality affects the income portfolio unexpectedly.

For management of risk there are certain measuring tools which help in suggesting the management techniques.

1. **Maturity Gap Analysis.** It helps in finding the sensitivity of the interest rate in relation to the gap between assets and liabilities.
2. **Duration Gap Analysis.** This measure the sensitivity of the interest rate to capital
3. **Value at Risk.** The analysts attribute this approach to bifurcation of banking business into segments and so classify the transaction on the basis of the nature

of various transactions. These transactions are classified into Trading Books and Banking Books. Trading Book assets are consisting on the primary assets held for generating revenue and making profit by investing for short term whereas the Banking Book comprise on assets and liabilities contracted for long term relationship and meeting statutory requirements.

The Trading Book assets focus on the price variation whereas the Banking Book assets and liabilities take care of the economic value of the entries. This method assess the market risk with the help of statistical techniques and measures the expected loss over a given time period (interval) under usual market scenario. Based on a confidence level Value at Risk Method is distribution of future probability and not the actual results which will be known only when the event takes place.

4. The Risk Management Process. To devise an effective risk management program the banker has to take certain measures before advancing money to an individual, a group or a company. These measures in fact help the banker to minimize the chances of possible loss. The initial measures may start from the establishment of relationship with the customer and it commences from the opening of account. The Application of Prudential Regulation and introduction of KYC (Know Your Customer) concept has minimized the chances of fake opening accounts which has been one of the means of fraudulent operation and unauthorized withdrawal of money. Thorough investigation about the antecedents of the prospective customer and thereby guarding against the impersonation has proved instrumental in minimizing the risk.

- a) Identify the probable or potential loss. Banker often does this by taking into account the average loss occurred during the previous years.
- b) Based on the past experiences he makes an evaluation of the losses which may occur during the process of recovery.. The bankers under the directives of State Bank of Pakistan ahs since started implementing Prudential Regulation and provisions are made on the basis of the default period.
- c) Rejda (1995) while discussing the risk management process suggested that selecting appropriate technique or a combination of techniques for treating loss exposures will avoid the losses

5. Credit Risk Management Tools. Risks associated with the approval and disbursement of credit can be minimized using the following tools.

- a) **Proposal Appraisal:** Every credit application must be scrutinized in terms of its economic and financial viability, future prospects of the business entity. Availability of inputs and marketability of the product are core issues

and need to be taken into account before taking a credit decision. Complete resumes of the applicants/ sponsors indicating experience, standing, and net worth, market reputation, sources of income and financial contribution or self investment. And complying with KYC requirements minimizes the mishap of impersonation and fake account.

- b) **Approval:** Each facility differs from other in terms of purpose, quantum, and collaterals. Depending on the nature of facility the finance sanctioning authority be defined with delegated powers. The level of authority will decide on the credit approval from case to case basis leaving least opportunity to be exploited. Amour (2014) in believed that effective corporate governance with a broadened vision is prerequisite for risk avoidance. He wrote; “Bank regulators are turning their focus from balance sheets to board rooms as they try to forestall the chance of another financial crisis by forcing banks to better understand and manage their own risks.” Forming of **Credit Approval Committees** to scrutinize the case and accord approval has always been help in minimizing the chances of wrong approval. The central Bank in Pakistan has been issuing instruction in line with envisaged prudential Regulations which must adhered to while according sanction to finance/loan applications.
- c) **Credit Exposure:** Besides collaterals, bank must observe per party limit which describes the eligibility of single party for availing a finance facility. Where individual borrower is eligible on the basis of investment in business coupled with collaterals, the firms and corporate sector entities are financed on the basis of net equity and minus charge on assets. State Bank of Pakistan i.e., Central Bank of the country has since fixed limits under Prudential Regulation No.1 which provides proper guidance on per party exposure limit to banks in allowing finance to various entities. Under the Prudential Regulation each party is allowed finance only within the overall exposure limits violation of which renders the bank liable for penalties.
- d) **Disbursement procedure.** No disbursement be allowed until all the documentation formalities as envisaged in the sanction advice are completed. Verification of documents before and after sanction is equally important lest fake title without physical securities is accepted which places the bank in trouble at the time of realization of securities. Continuous verification and evaluation of securities needs to made part of the responsibility of the disbursing office. Regular effective monitoring and control system helps in identifying the trend in business and so the repayment capacity of the borrower. Keeping close vigilance over the status of a finance /loan the bank must follow the aging guidelines provided in the

form of prudential regulations for in time classification and initiating efforts for immediate recovery.

- e) **Per party exposure.** Capital adequacy ratio requirements both in respect of lending bank and the prospective borrower helps in determining the eligibility of the borrower and also power of banker which limits must be observed. The existing Prudential Regulation No.1 part-B which has puts limit on exposure to a single person guides in making credit decisions and links the bank's lending power with capital adequacy . The regulations restrict the power of a banker to the prescribed limit of the bank's own net equity.
- f) **Pricing of Loan/ Finance.** At times there was a concept that greater the risk of loss the higher will be the rate of interest /return. This very concept loses weight when we discuss Risk Management because raising the rate of interest means overburdening the borrower and further increasing the rate and chances of risk. Instead, borrower be selected on the basis of merit which means better and brisk business trend and worth of the borrower.
- g) **Diversification of portfolio.** A wise man does not put all the eggs in one basket. The assets allocation be made on the liquidity preferences. Concentration of exposures will eventually lead to greater risk ratio. Diversification of portfolio has always been a wise decision from the banker's point of view. A scrupulous banker, therefore, never puts all the eggs in one basket. Also see that lending continues so long as the business of the borrower shows signs of prosperity and growth. The moment banker feels that the borrower's business shows a declining trend the banker initiates efforts to recover the amount. Wise banker lends the umbrella when it is shining and immediately withdraws when it rains.
- h) **Control Mechanism.** A dog's watch on the operations in account of the borrower as well as the turnover in the business of the borrowing entity guides in noticing danger signals. A downward trend points to cautious treatment lest the default may ultimately lead to a big disaster. The Lehman Brother and Company of United States of America collapsed due to imprudent Mortgage Financing and became one of the causes of Global Financial Crisis. Therefore, strong and effective audit and inspection and its timely implementation for removal of anomalies detected on regular basis as well as on surprise check basis will mitigate the risk of loss. There must be **Credit Review System** which may periodically review individual cases in terms of Prudential Regulations No 11 and ensure that proper in time classified, provisioning is made and preventive measures are taken before a party violates any of the Regulations.

- i) **Insurance Coverage.** Till the end of 20th century banks had mostly been relying on the Insurance Cover to mitigate their risk. Although in some cases the insurance companies have been helpful in reducing the quantum of losses caused to a banking unit but the risk still remains associated with the business because of unpredictable future events. Although the prudent bankers always make all out efforts to forecast the contingent liabilities, yet 100% provision and providing cushion has not been advisable in the business of banking. Again lengthy and complicated claim realization procedure also cost which expenses are born by the bank exclusively. Then depreciation, depletion and conveyance losses also reduce the claimed amount in spite of premium paid. Therefore, insurance policy is one of the risk mitigates and cannot relied upon exclusively.

Suggestions

Management Control System

For effective preventive measure the designing /development and implementation of Strong Management Control system is a pre requisite. All efforts for minimizing the risk will go in vain if the Control system is weak and ineffective. Any loophole in this system itself invites misappropriation, misuse, unauthorized disbursement and non recovery due to either connivance or ignorance. An effective system ensures risk free operation for the achievement of this objective emphasize upon preventive measures instead of detective. The Management Control System is responsible for plugging these loopholes by identifying the discrepancies ,irregularities and malpractice, guiding the organization to improve the performance through strict vigilance, close cooperation among the various tiers of the organization and developing the Human Resources to shoulder their responsibilities with all honesty, efficiency and diligence. Conventionally banks rely on periodical audit of accounts and inspection. This exercise is beneficial only to the extent of identification and detection of the irregularities and discrepancies.

However, the basic issue of risk remains intact because its elimination or for that matter mitigation preventive measures are required to be suggested and implemented which audit and inspection fails to ensure. The observations in audit reports are, no doubt, dealt with through compliance but the process of compliance remains restricted to the extent of removal of the discrepancies detected. Independent Management Control System will cater to the overall efficiency needs of the organization. The System will not only be confined to the monitoring and supervision but give equal importance to the skill development and behavioral improvement of the Human Resources which, in fact, plays decisive role in risk minimizing process of the organization.

Good Governance

Systems do not automatically operate. System is developed to guide and control the human activities for achieving the organizational goals. The development of system and its operation will be useful when it has been built with all expertise. The activity of system building, therefore, needs an honest team to design and build. Again the operation requires sincere organizational support for its real success. The management and control system lose its efficacy if the governing body has ulterior motives and least care for the proper application of the regulations which have been approved for the conduct of business smooth and safe. Connivance on the misconduct, least interest in the application of rules of business, absence of control and check, non existence of coordination and cooperation among the various tiers of management encourage the vested interest to exploit and ultimately turn the organization a total failure. It the top hierarchy which is responsible for the ensuring the organizational activities to be carried out in accordance with the predetermined objectives by fair distribution of operational results. No doubt effective Control System is a key to success in the process of Risk Mitigating yet the success of Control System lies in its strict implementation by the top hierarchy. Hence the need of Corporate Good Governance cannot be over emphasized.

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