FINANCE MANAGEMENT

# "FINANCIAL FLEXIBILITY AND OPERATIONAL RISK MANAGEMENT IN BANKS"

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Every country, on the global planet has ultimate aim of development, irrespective of system of development is to achieve maximum human welfare. For this a country has to make huge productive investments, in leading sectors in the economy. The commercial banks are the biggest financial intermediaries in the economy. The banks play a vital role in collecting the scattered savings of households, corporate savings and government savings. These savings are channelized as loanable funds into productive investment in the economy. Thus banks are monetary blood banks for promoting sustainable development in the economy. Therefore, operational financial flexibility is a key issue in determining their efficiency, productivity and profitability.

The commercial banks had relatively high financial flexibility during 1947 to 1968. During this period of time, the banks were owned and managed by private sector. The banks had flexibility in pricing their assets and liabilities, assets allocations, branch expansion customers mix and market segmentation. As a result of financial flexibility banks had accumulated substantial profits.

Our government in 1969, nationalized the fourteen leading commercial banks. Since nationalization of banks, they have lost their financial flexibility. The banks had no financial flexibility in pricing their assets, allocation of assets, branch expansion customers mix and market segmentations. Even in certain segments of priority sector lending bank funds were provided under concessional finance / differential rate of interest scheme below the cost of funds. The government also utilized substantial

bank funds for development at low rate of interest. As a consequence of lack of financial flexibility to the banks, they had serious problems of low productivity, inefficiency low profitability and losses.

In 1990 our government realized that the growing inefficiencies, low productivity and losses in public sector enterprises including banks were due to the model of growth founded on public sector. Therefore, in 1991, government introduced the economic reforms viz liberalization, privatization and globalization (LPG). By liberalization all controls were removed. The model of growth built on public sector has been dismantled and Indian economy is integrated to global economy. Thus Indian economy is geared to the market mechanism. As a result of market economy, the management is sensitized for quality, productivity, cost and customer service.

The foreign banks entered into Indian financial market for business. These banks have financial flexibility, new products profiles, modern technology based banking operations, aggressive customer focus banking and customer care and customer service. In order to make our banks comparable and competitive with foreign banks the financial flexibility to the banks was advocated. Therefore government appointed the committee on financial sector reforms, chaired by Narsimham. The Narsimham Committee submitted its report in 1991 and mainly focused its recommendations on financial flexibility and autonomy to the banks.

The Committee observed that lack of financial flexibility to the banks due to over regulation and excessive supervision resulted into deterioration in the health and asset quality of the banking system as indicated by the large sickness in the banks, bad and doubtful debts, losses etc.

Reserve Bank of India (RBI), the statutory regularity and supervisory authority has progressively introduced the banking sector reforms recommended by the Narsimham Committee to provide financial flexibility and autonomy to the banks. RBI has also directed to the banks to use modern information technology for financial inclusion in the country.

The growing use of information technology, in banks has provided maximum financial flexibility for complex and huge volume of business, large number of heterogeneous customers, vast geographical areas, complex & multiple new products and services profiles, different types of accounts, and emerging new business in global market. The growing use of information technology in banks has helped them to reduce their banking cost, cost of human resources and increase in productivity.

The information technology has become the major input mechanism for banking operations. The vast technology infrastructure, process, systems & people have become the critical key segments of banking operations. The failure of people, systems and process will lead to failure in banking operations and thereby a failure of an organization. Therefore, banks are subject to an operational risk because of internal failure in its operations. The failure of internal operations controls resulted into sensational Harshad Mehta scam in the Banking industry in our country.

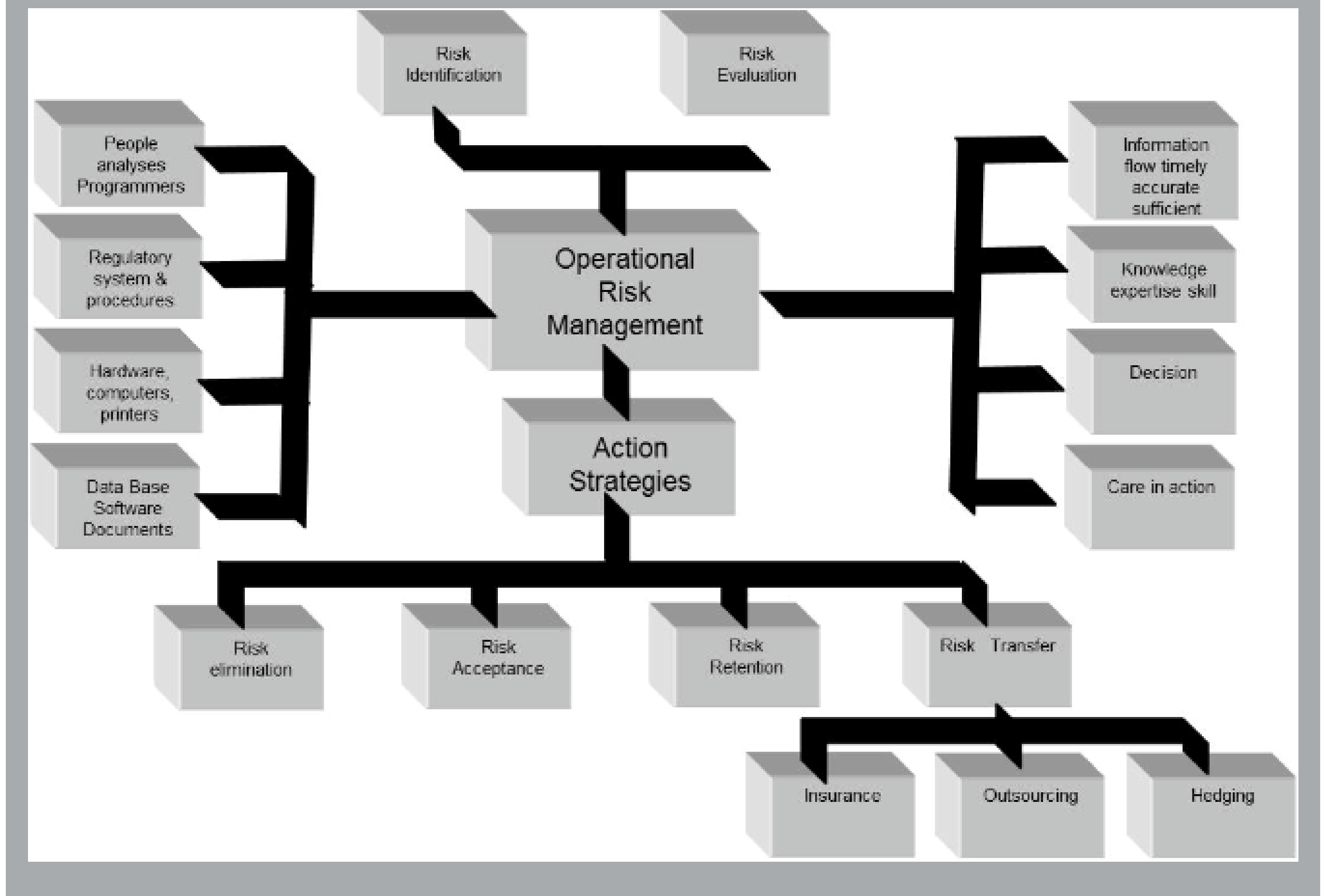
The operational risk relates to information assets. These are tangible assets comprising of hardware, minicomputers, printers, printed materials, programmers, furniture etc. The assets that are conceptual in nature are software, data, information, policies and procedures.

The operational risk management is also subject to the external and internal threats. Therefore, the Operational Risk Management (ORM) has to assess the risk in terms of its occurrence, and magnitude of loss. This will help the operational risk management to design the strategy to monitor the risk. The operational risk management can resort to the strategy of risk elimination, reduction, retention and transfer.

The exhibit I shows the structure of operational risk management.

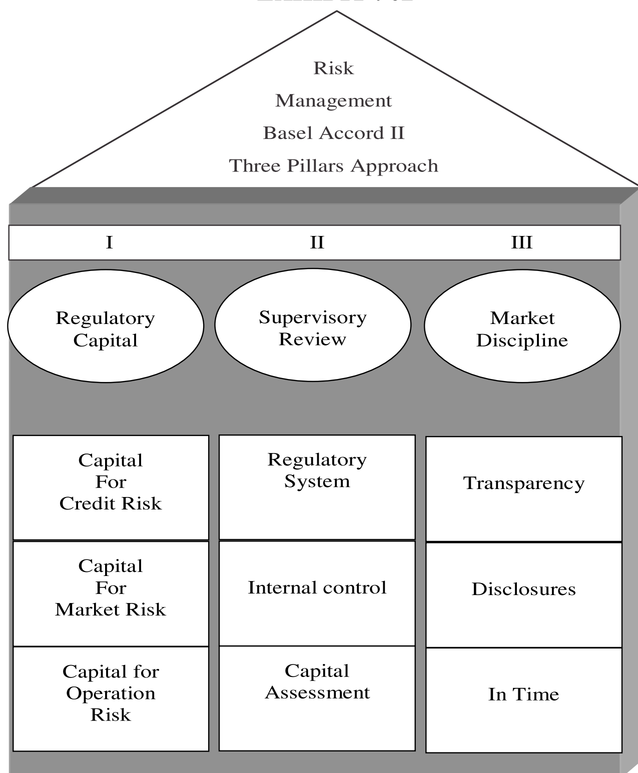
**EXHIBIT I**

**OPERATIONAL RISK MANAGEMENT IN COMMERCIAL BANKS**




The Basel Committee on Banking Supervision has done the pioneering work in the areas of risk management for promoting the international banking on sound line. The Basel Committee comprising of the Governors of central banks of ten countries was formed in 1975. The Basel Committee produced the first document on 'International Convergence of Capital Standards', in July 1988, for creating safety and stability of global commercial banking. The Basel Committee in June 2004 published the second accord. The Basel Committee Accord Second has classified the risk into three categories viz, Credit risk, Market risk and Operational risk.

The second Basel Committee Accord defined the operational risk as the risk of loss resulting from inadequate or failure of internal processes, people and system or from external events. In order to create a structured framework of risk management in banks, the Basel Committee has innovated three foundation pillars of risk management system, which is exhibited in the following exhibit II.




## OPERATIONAL RISK MEASUREMENT MODEL

The operational risk measurement model is briefly explained as under

### 1. SCALAR MODEL

The key business variables are identified. The operational risk is calculated as a percentage of these key business variables. The Basel Committee has suggested two approaches viz.

### A. BASIC INDICATOR APPROACH (BIA)

The capital calculated for operational risk is equal to the average of previous three years of a fixed percentage of positive annual gross income. The same can be put in the form of equation as under :

$$Y = \frac{Y_1 + Y_2 + Y_3}{3}$$

= Average of three years positive annual income.

**Operational Risk**

1st year Y1/Y * 100

2nd Year Y2/Y * 100

3rd Year Y3/Y * 100

### B. STANDARDIZED APPROACH (SA)

Under this approach the major business activities of the bank is divided into eight portfolios viz.

I. Corporate Finance

ii. Trading and Sales

iii. Retail Banking

iv. Commercial Banking

v. Payment and Settlement

vi. Agency Services

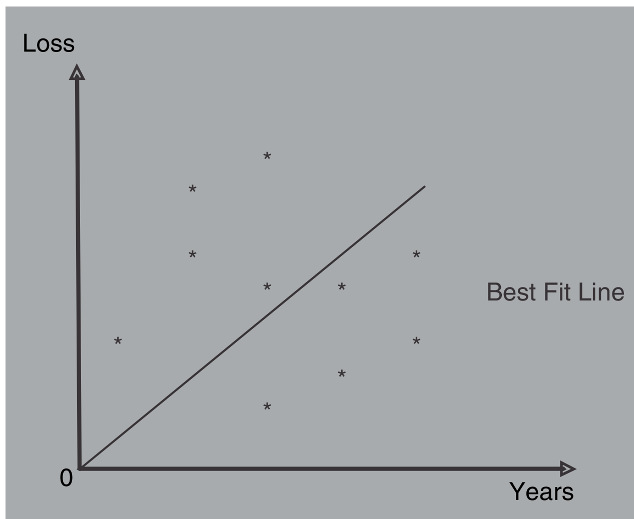
vii. Asset Management

viii. Retail Brokerage

The capital charge for each business portfolio is separately calculated by respective percentage. The total capital is calculated as the three year average of the simple summation of the regulatory capital charges across each business line in the year.

### 2. STATISTICAL APPROACHES

The statistical models are used in this method. The loss data of past years is an input of building statistical models. The statistical tools like 'Time Series Analysis' of moving average method can be used for this purpose. The past years loss data is arranged in a chronological order. It becomes a time series data of loss. It shows the trend behavior of loss. Based on trend behavior of the variable viz loss, the future trend behavior of loss can be illustrated with the help of diagram of freehand method.




3. FUZZY LOGIC

In this method, sensitivity risk variables are identified at each level of an organization hierarchy. Such sensitive variables are aggregated at the each level of an organization' hierarchy. The ranked risk variables show their significance in terms of their hierarchy level in the organization. The key risk indicators are identified. Then the scaling technique is used to know their key influences. This technique focus on the key risk drives in the hierarchy structure of an organization.

4. CAUSAL MODEL

In this model, causes and effects of operational losses are ascertained. The operational losses occur due to an adverse influence of certain factors. Such factors can be identified and significance efforts of these factors can be checked.

CONCLUSION

During 1947 to 1968 banks had Financial Flexibility in terms of pricing of assets and liabilities, allocation of assets, customer mix and branch expansion. Since 1969 to 1990, banks lacked financial flexibility, due to over regulation & supervision which resulted into deterioration in their health and assets quality.

The economy reforms and financial sector reforms have influx a great deal of financial flexibility for the banks.

The banks management is inherited to manage the credit risk and liquidity risk. Now, the expansion in scale of banking operations due growing retail banking, investment banking, electronic banking, new product profiles and global banking have shifted to high-tech banking. The digital revolution has influenced the revolution in banking operations. The banking operations are now information technology oriented. The fabrics of modern IT have embraced the fabrics of baking operations to deal with mass and diversified banking business at lowest cost, high productivity performance and high profitability through modern IT is subject to an operational risk.

The Operational Risk Management (ORM) has to place a focus driven attention on IT, software model & operative personnel. The bank management should install in a phase manner the suitable IT infrastructure with the help of professional experts. A task force of technically competent persons should be deployed to monitor its maintenance and work efficiency. A task force should also effectively supervise its functioning.

In order to minimize the probability of operational risk, the bank management should hire the services of software experts for designing an appropriate software model for the bank. The software model should be designed on the principle of need base approach. The software model should be prepared in such a way that there is no possibility of lacuna in banking operations. It must be full proof model.

The operational risk may arise because of operative personnel. The operative personnel may be inefficient, ignorant and inexperience. Therefore, the bank management must recruit the persons who possess the required knowledge, experience and expertise of operating the modern technology.

The bank management should create a training center for training and up grading the existing operative skill and expertise. A proper feedback of training is necessary to improve the existing training input and system.

The operational risk can also outburst due to willful act of operative personnel. To restrict such operational risk, the proper procedure and rules should be made effective along with an effective

supervision and control.

Finally, in an emerging scenario of global banking the operational risk management is a new risk prone area with its multi complexities. Moreover, reward and risk are sensitively related. Therefore, risk management must focus on risk inventory, risk synchronization, risk reduction and risk diversification. Along with this risk base audit (RBA) risk based supervision (RBS) and effective internal control system are must for banking operations for monitoring the operational risk and ensuring stability.

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