OPERATIONAL RISK MANAGEMENT IN BANKING – A STUDY OF J&K BANK

Viqar_U-Nissa *
Mushtaq A Darzi*

Introduction:

There are many connotations of risk that vary by specific application and situational context. From one perspective, "risks" are simply the future issues which can be avoided or mitigated, rather than present problems that must be immediately addressed. Risk is inherent in any walk of life in general and in financial sectors in particular. Risk at the apex level may be visualized as the probability of a banks' financial health being impaired due to one or more contingent factors. Till recently, due to regulated environment, banks could not afford to take risks. A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. In doing their businesses banks are often faced with a double edged sword of risk & returns & they have to balance the two in order to survive & generate profits. If the concept of risk management is applied to banking sector then banks are invariably faced with different types of risks that may have a potentially negative effect on their business. The major financial & non financial risks encountered by the banking sector as per the Reserve Bank of India guidelines issued in Oct. 1999 are market risk, operational risk and credit risk.

Market risk can be defined as the risk arising from the adverse changes in the market variables such as interest rate, foreign exchange rate, equity price and the commodity price. Credit risk is the risk of loss due to a debtor's non-payment of a loan or other line of credit (either the principal or interest (coupon) or both). The default events include a delay in repayments, restructuring of borrower repayments, and bankruptcy. Thus credit risk is most simply defined as the potential that a bank borrower or counterpart will fail to meet its obligations in accordance with agreed terms. Operational risk is a risk arising from execution of a company's business functions. As such, it is a very broad concept including e.g. fraud risks, physical or environmental risks, etc. The term operational risk is most commonly found in risk management programs of financial institutions that must organize their risk management program according to Basel II. Operational risk arises from faulty business practices or when buildings, equipment, and other property required to run the business are damaged or destroyed.

The identification and measurement of operational risk is a real and live issue for modern-day banks, particularly since the decision by the Basel Committee on Banking Supervision (BCBS) to introduce a capital charge for this risk as part of the new capital adequacy framework (Basel II). The Basel Committee defines operational risk as, "The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." Basel II and various supervisory bodies of the countries have prescribed various soundness standards for operational risk management for banks and similar financial institutions. To complement these standards, Basel II has given guidance to 3 broad methods of capital calculation for operational risk:

- Basic Indicator Approach – based on annual revenue of the financial institution.

* Assistant Professor Department of Management Studies North Campus University of Kashmir
* Professor Department of Business School University of Kashmir

- Standardized Approach – based on annual revenue of each of the broad business lines of the financial institution.
- Advanced Measurement Approaches – based on the internally developed risk measurement framework of the bank adhering to the standards prescribed (methods include IMA, LDA, Scenario-based, Scorecard etc).

NEED OF THE STUDY:

Banking system is exposed to many risks and in particular the banks are exposed to credit, market and operational risks. In this regard a study has been undertaken and the bank that has been chosen is J&K Bank because it is a pioneering bank of the state. The present study has been confined to the management of operational risk in J&K Bank and its preparedness for higher approaches. The study has been focused on operational risk management because it is the area of the risk management where not much work has been done. Based on the findings of the study, recommendations have been made so that the bank improves upon the area of operational risk management.

Objectives of the Study:

The study has been conducted keeping the following objectives in view:

1. To study and compare the position of J&K Bank with respect to the guidelines put forth by RBI for the implementation of operational risk management framework.
2. On the basis of the results of the study, put forth the suggestions and recommendations outlining their policy implications for improving the management of operational risk in J&K Bank.

Research Approach:

The research approach adopted for the study consists of the following:

1. Assessment of the present Operational risk Management policy of J&K Bank.
2. Detailed analysis of the status of J&K Bank in terms of its management of operational risk. This has been primarily done by comparing the J&K Banks operational risk management policy with that of the guidelines put forth by RBI.

Data Source:

The data relating to the study has been collected through the secondary sources. The various secondary sources i.e. BASEL operational risk framework, RBI guidelines and J&K Banks operational risk management policy were analysed for the purpose of understanding the status of J&K Bank in terms of operational risk management.

J&K Bank's Status With Respect To Rbi Guidelines For Operational Risk Management: The Reserve Bank of India (RBI) is the regulator and supervisor of the banking system in India and is entrusted with the task of framing the capital adequacy guidelines for banks in India under Basel II. Thus RBI has issued guidelines which form an outline of a set of sound principles for effective management and supervision of operational risk by banks. Thereafter, banks use these guidelines for upgrading their operational risk management system. Like most of the banks in India, the J&K Bank has so far been trying to implement the guidelines put forth by the regulatory body for banking in India i.e. RBI and has been successful in various aspects of the guidelines with respect to the management of operational risk. Keeping in view the RBI guidelines, a comparison has been drawn between the current position of J&K bank in terms of the management of its operational risk and the criteria's put forth by the RBI for the implementation of operational risk management framework. The status of J&K bank in terms of RBI guidelines for the operational risk management is presented below:

1. Organizational Set-up for Operational Risk Management:

Operational Risk Management has been identified as one of the important pillars for Integrated Risk Management framework in the J&K bank and an appropriate organizational set up has been put in place with clear definition of responsibilities at each level. The operational risk management organization structure in the bank has been structured as per the guidelines of RBI with the Board of Directors exercising the complete oversight and control of the Operational Risk Function. Operational risk framework adopted in J&K bank follows a top down approach. Instructions/observations made at Board level are followed and implemented down the hierarchal levels. Ideally, the organizational set-up for operational risk management as per RBI guidelines should include the following:

a) Board of Directors.
b) Risk Management Committee of the Board.
c) Operational Risk Management Committee.
d) Operational Risk Management Department.
e) Operational Risk Managers.
f) Support Group for operational risk management.

The J&K Bank has been successful in having the organizational set up as per RBI guidelines. In addition to this, the bank has extended their structure for the efficient and effective management of operational risk in their organization. In this regard the bank has included Business Unit/Department/Zonal Heads, Operational risk Managers/Zonal Level Nodal Operational Risk managers and Internal Supervision and Control Division so as to ensure that the operational risk management is taken care of at the zonal and operational (i.e. functional) level and not only at the corporate headquarter level. The Zonal Level Nodal Operational Risk managers are required to report two types of loss events to the operational risk management group:

- Actual losses exceeding Rs. 5000, and
- Near misses.

2. Policy Requirements and Strategic Approach:

Bank understands the importance of operational risks vis-a-vis their criticality and effective management/mitigation. Bank has a well-defined operational risk structure with hierarchal levels properly defined along with roles and responsibilities. A comprehensive Operational Risk policy and BCP has also been devised, these policies envisage to address Operational Risk issues positively on continuing basis. Operational Risk Management policy, BCP is already in place and approved by Board. The primary objective of the Operational Risk Management (ORM) policy is to provide strategic direction and ensure an effective ORM throughout the Bank. It gives a direction to the bank so that it can identify and assess the Operational Risk inherent in all material products, activities, processes and systems and also initiate necessary actions to monitor and mitigate those risks.

3. Identification of Operational Risk:

Various losses resulting due to operational risk have been identified in the operational risk policy. However, there still exist many areas, which are to be addressed. So far the bank has hired a group of two employees who have been assigned the task of risk identification and profiling. For the purpose of identifying risk events the bank has also listed out the activities that are susceptible to operational risk. The list of such activities has been taken to be same as the business lines used for the measurement of Operational Risk capital using Standardized Approach. These are: Corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage. The bank has been and is trying to break down each of these business lines into its sub processes like transaction banking, trade finance, general banking, cash management etc. for risk factor mapping. Following principles of Risk Event recognition have been followed while Risk mapping the Processes:

(i) **Experience**: The event has occurred in the past.
(ii) **Judgment**: Business logic suggests that the bank is exposed to a risk event;
(iii) ***Intuition****: Events where appropriate measures saved the institution in the nick of time;*
(iv) **Linked Events**: This event resulted in a loss resulting from other risk type (credit, market etc.);
(v) **Regulatory requirement**: Regulator requires recognition of specified events.

Based on the operational risk profile of the bank, Credit, Treasury and Remittances have been identified as the high-risk processes for the Bank, which were risk mapped for each operational risk loss event.

4. of Operational Risk:

At present there is no clearly established, single way to assess/measure operational risk on a bank-wide basis. RBI has suggested Banks to develop risk assessment techniques that are appropriate to the size and complexities of their portfolio, their resources and data availability.

In order to assess the likely operational risk exposure of the Bank, J&K bank has been using the Severity-Frequency Matrix for calculating the probability of each risk loss event. The matrix has been developed with the help of workshops conducted with the relevant operational risk and business line managers who were required to classify each risk loss event on a scale of 1 to 5 for severity and frequency based on their experience and other guiding principles.

5. Monitoring of Operational Risk:

Monitoring is done mainly based on the reports such as reports on critical system failure and reports on losses occurring due to frauds/dacoits etc. However there is a need of putting in place an operational risk database that could serve the purpose of effective management and reporting on Operational risk. Presently the bank is working to monitor the Operational Risk on the basis of impact assessment prioritization. Loss events above a threshold are being and will be comprehensively monitored and tested for appropriate controls. For high risk events proper Escalation triggers are being developed. Escalation trigger is the minimum limit set to provide early warning signal for a specific or group of loss events.

6. Reporting of operational risk:

In order to implement the operational risk management processes and enable the bank to identify and assess the operational risk on an ongoing basis, the J&K Bank has adopted a new policy and is in the process of its implementation. Each business unit is required to compile information on various operational risk events and report both actual losses and near misses to their respective Zonal level Nodal operational Risk managers, who in turn will forward this information to the ORMG at CHQ. A threshold limit of

Rs.5000/- and above is fixed for reporting of operational risk loss events. Reporting of loss data is the joint responsibility of Business unit/Department level Operational Risk Manager and Business unit Head/Department Head. It is also the responsibility of the concerned Zonal Nodal Operational Risk Managers to collect and compile information from business units/offices falling under jurisdiction of their Zonal offices and forward the same to ORMG at CHQ. In this context, any event or incident based on any of the spheres of operational risk are being considered which has the potential to cause business disruptions, financial loss or damage to the bank's reputation and assets.

The J&K Bank has also fixed a threshold limit of Rs.10000/- and above for all operational risk loss events which need to be reported immediately to the ORMG for analysis and reporting to ORMC/Top Management. Other operational risk loss events below the threshold limit are to be collected at regular intervals i.e. on quarterly basis by ORMG from all the controlling offices.

7. Controls / Mitigation of Operational Risk:

Bank has a well-defined internal control system in place through policies, procedures and directives. The J&K Bank has a system of internal audit which has the responsibility to check whether the operational risk framework is being implemented efficiently at the grass root level. The bank has also the risk based internal audit (RBIA) in the Supervision and Control Department which rates the branches of the bank on a scale based on some operational risk parameters.

8. Capital Allocation for Operational Risk:

The J&K Bank is currently computing capital charge for operational risk based under the Basic Indicator Approach but at the same time the bank has started using standardized approach as a parallel run since the last quarter of 2009. Reserve Bank has proposed that, at the minimum, all banks in India should adopt this approach while computing capital for operational risk while implementing Basel II.

Conclusions & Recommendations:

Within the broad spectrum of objectives, the study was undertaken to probe into the ways the operational risk is being managed at J&K Bank. In this regard a study was carried out where an analysis was done so as to find out the status of operational risk management in J&K Bank in comparison with the guidelines of operational risk management framework put forth by RBI. The analysis done in the foregoing pages has revealed the following points:

1. With respect to the implementation of the operational risk management framework put forth by RBI, the position of J&K Bank is strong in papers as is clearly revealed by the J&K Banks operational risk management policy.
2. It was observed that the bank has made certain additions to that of the RBI guidelines so as to ensure that the operational risk events are properly managed, mitigated and reported in the organization. One of those attempts made by the bank is the extension in their structure (i.e. zonal heads and operational risk managers) for the efficient and effective management of operational risk in their organization.
3. Also, the bank is presently calculating the capital charge using the basic indicator approach but at the same time the bank has started using standardized approach as a parallel run since the last quarter of 2009. The bank has already issued orders and is in the process of obtaining the loss data from its branches so that it switches over to the higher approaches for the calculation of capital charge.

4. It has also been found that the bank has a strong compliance with the RBI guidelines in terms of its policy.

So the findings of the study clearly reveal that the J&K Bank is working in the area of operational risk management but the pace is slow. In this regard few suggestions have been put forth that will ensure the better management of operational risk both at the corporate headquarter level and the branch level. These have been presented below:

1. Operational risk managers and all the concerned officers should be imparted a high tech training and more information should be provided on the subject of operational risk.
2. The staff at the CHQ level as well as the branch level should be communicated the changes and the updates with respect to the guidelines of the management of operational risk.
3. Better infrastructure and IT facilities should be made available to all the branches of J&K Bank.
4. A special operational risk management team should be made and assigned the task of keeping a track of operational risk events that have occurred in the branches.
5. Categorization of all the possible operational risk events in all the areas of banking operations (e.g. loan origination, term deposits, withdrawals, account opening etc) should be done and the same should be circulated to all the operational risk managers at the branch level.
6. Last but not the least, J&K Bank needs to have credible, transparent, well documented and verifiable operational risk management function.