RISK ISSUES BANK FINANCIAL INSURANCE

Chapter - 5

RISK

In simple terms, **risk** is the possibility of something bad happening. The variability of return on an investment is called risk. Risk is the possibility that an investment's actual return will be different from expected.

"Risk is defined in financial terms as the chance that an outcome or investment's actual gains will differ from an expected outcome or return. Risk includes the possibility of losing some or all of an original investment."

- Investopedia

"Risk is the chance of financial loss"

- L.J. Gitman

UNCERTAINTY

Uncertainty refers to situations under which either the outcomes and/or their probabilities of occurrences are unknown to the decision-maker.

*“**Uncertainty** refers to epistemic situations involving imperfect or unknown information. It applies to predictions of future events, to physical measurements that are already made, or to the unknown.”*

- Wikipedia

RISK VS UNCERTAINTY

BASIS FOR COMPARISON	RISK	UNCERTAINTY
Meaning	The probability of winning or losing something worthy is known as risk.	Uncertainty implies a situation where the future events are not known.
Ascertainment	It can be measured	It cannot be measured.
Outcome	Chances of outcomes are known.	The outcome is unknown.
Control	Controllable	Uncontrollable
Minimization	Yes	No
Probabilities	Assigned	Not assigned

ASSETS-LIABILITY MANAGEMENT (ALM)

Asset/liability management is the process of managing the use of assets and cash flows to reduce the firm's risk of loss from not paying a liability on time. Well-managed assets and liabilities increase business profits. The asset/liability management process is typically applied to bank loan portfolios and pension plans.

ALM sits between risk management and strategic planning. It is focused on a long-term perspective rather than mitigating immediate risks and is a process of maximizing assets to meet complex liabilities that may increase profitability.

"**Asset and liability management** is the practice of managing financial risks that arise due to mismatches between the assets and liabilities as part of an investment strategy in financial accounting."

- Wikipedia

RATE SENSITIVE ASSETS(RSA)

Rate sensitive assets are bank assets, mainly bonds, loans and leases, and the value of these assets is sensitive to changes in interest rates; these assets are either repriced or revalued as interest rates change.

“Interest sensitive assets are financial products whose features and characteristics or their secondary market price are vulnerable to changes in interest rates.”

-Investopedia

Interest-sensitive assets become more profitable or less profitable as lending rates increase or decrease. If interest rates rise, a bank earns more profit from mortgages and other loans. If interest rates fall, the consumer keeps more money and spends it elsewhere. The trends in overall interest rates drive the economy or slow it down.

RATE SENSITIVE LIABILITIES(RSL)

Rate sensitive liabilities are bank liabilities, mainly interest-bearing deposits and other liabilities, and the value of these liabilities is sensitive to changes in interest rates these liabilities are either repriced or revalued as interest rates change.

Interest sensitive liabilities are short-term deposits with variable interest rates that a bank holds for customers.

Interest-sensitive liabilities are based on variable rates, banks have to manage the corresponding interest rate risk due to changes in rates over time. Examples of interest-sensitive liabilities are money market certificates, savings accounts etc.

WHY BANK SHOULD BE CONCERNED ABOUT RISK?

- Credit Risks
- Market Risks
- Operational Risks
- Liquidity Risk
- Business Risk
- Reputational Risk
- Systemic Risk

TYPES OF RISK

A. **Systematic risk**

a. Interest rate risk

I. Price risk

II. Reinvestment rate risk

b. Market risk

i. Absolute risk

ii. Relative risk

iii. Directional risk

iv. Non directional risk

v. Basis risk

vi. Volatility risk

TYPES OF RISK

c. Purchasing power/inflationary risk

i. Demand inflation risk
ii. Cost inflation risk

B. **Unsystematic risk**

a. Business risk/ Liquidity risk

i. Asset liquidity risk
ii. Funding liquidity risk

b. Financial risk/Credit risk

i. Exchange rate risk
ii. Recovery rate risk
iii. Sovereign risk
iv. Settlement risk

TYPES OF RISK

c. Operational risk

i. Model risk
ii. People risk
iii. Legal risk
iv. Political risk

SYSTEMATIC RISK VS UNSYSTEMATIC RISK

BASIS FOR COMPARISON	SYSTEMATIC RISK	UNSYSTEMATIC RISK
Meaning	Systematic risk refers to the hazard which is associated with the market or market segment as a whole.	Unsystematic risk refers to the risk associated with a particular security, company or industry.
Nature	Uncontrollable	Controllable
Factors	External factors	Internal factors
Affects	Large number of securities in the market.	Only particular company.
Types	Interest risk, market risk and purchasing power risk.	Business risk and financial risk
Protection	Asset allocation	Portfolio diversification

BUSINESS RISK VS FINANCIAL RISK

BASIS FOR COMPARISON	BUSINESS RISK	FINANCIAL RISK
Meaning	The risk of insufficient profit, to meet out the expenses is known as Business Risk.	Financial Risk is the risk that a business will not be able to generate enough cash flow & income to pay their debts & meet their other financial obligations.
Evaluation	Variability is (Earnings Before Interest & Taxes)EBIT	Leverage Multiplier and Debt to asset ratio.
Connected with	Economic environment	Use of debt capital
Minimization	The risk cannot be minimized.	If the firm does not use debt funds, there will be no risk.
Types	Compliance risk, operational risk, reputation risk, financial risk, strategic risk etc.	Credit risk, Market risk, Liquidity risk, exchange rate risk, etc.
Disclosed by	Difference in net operating income and net cash flows.	Difference in the return of equity shareholders.

PURE RISK

Pure risk is a category of risk that cannot be controlled and has two outcomes: **complete loss or no loss at all**. There are no opportunities for gain or profit when pure risk is involved.

Pure risks can be divided into three different categories: personal, property, and liability. There are four ways to mitigate pure risk: reduction, avoidance, acceptance, and transference. The most common method of dealing with pure risk is to transfer it to an insurance company by purchasing an insurance policy.

Pure risk is generally prevalent in situations such as natural disaster, fires, or death. These situations cannot be predicted and are beyond anyone's control. Pure risk is also referred to as absolute risk.

TYPES OF PURE RISKS

1.Personal risks

2.Property risks

3.Liability risks

1. Personal Risks

These are the risks that directly affect the individual's capability to earn income. Personal risks can be classified into the following types:

Premature Death: Death of the bread earner with unfulfilled or non-provided financial obligations.

Old Age: It refers to the risk of not having sufficient income at the age of retirement or the age becoming so that mere is a possibility that the individual may not be able to earn the livelihood.

TYPES OF PURE RISKS

Sickness or Disability: The risk of poor health or disability of a person to earn the means of survival. E.g. the possibility of damage to limbs of a driver due to an accident.

Unemployment: The risk of unemployment due to socio-economic factors resulting in financial insecurity.

2. Property Risks

These are the risks to the persons in possession of the property being damaged or lost.

The immovable like land and building being damaged due to flood, earthquake or fire, the movables like appliances and personal assets being destroyed due to the fire or stolen.

The losses may be direct or indirect/consequential.

Whereas, the indirect ones are the losses arising from the occurrence of an incident resulting in direct/physical damages or loss.

The loss to crops due to flood is a direct loss – the destruction of the growing power is a consequential one.

TYPES OF PURE RISKS

3. Liability Risks

These are the risks arising out of the intentional or unintentional injury to the persons or damages to their properties through negligence or carelessness.

Liability risks generally arise from the law. e.g. liability of the employer under the workmen’s compensation law .

Risks may also arise due to the failure of others.

For example, the financial loss arising from the non-performance or standard performance in a contract, in engineering or construction contracts.

SPECULATIVE RISK

Speculative risk is a category of risk that, when undertaken, results in an uncertain degree of gain or loss.

Speculative risks are made as conscious choices and are not just a result of uncontrollable circumstances. Since there is the chance of a large gain despite the high level of risk.

Sports betting, investing in stocks, and buying junk bonds are some examples of activities that involve speculative risk.

OFF BALANCE SHEET RISK

Off-balance sheet (OBS) items is a term for assets or liabilities that do not appear on a company's balance sheet. Although not recorded on the balance sheet, they are still assets and liabilities of the company.

Off-Balance-Sheet Risk — the risk posed by factors not appearing on an insurer's or reinsurer's balance sheet. Excessive (imprudent) growth and legal precedents affecting defense cost coverage are examples of off-balance-sheet risk.

“OBSRs” broadly as a term describing obligations, contingencies, or potential accounting losses that do not appear on - or are inadequately disclosed in-a company’s balance sheet. OBSRs represent the possibility or “hazard” that these undisclosed items will cause unexpected changes in firm cash flow, liquidity, or leverage.

OPERATIONAL RISK

Operational risk is the prospect of loss resulting from inadequate or failed procedures, systems or policies.

- Employee errors
- Systems failures
- Fraud or other criminal activity
- Any event that disrupts business processes

Operational risk is heavily dependent on the human factor: mistakes or failures due to actions or decisions made by a company's employees.

TECHNOLOGICAL RISK

Technology risk refers to any risk of financial loss, disruption or damage to the reputation of an organization as a result of the failure of its information technology systems. Cyber risk is a subset of technology risk, which is the potential for any type of technology failure to disrupt a business.

Technology risk, or information technology risk, is the potential for any technology failure to disrupt a business.

Companies face many types of technology risks, such as information security incidents, cyberattacks, password theft, service outages, and more.

MATURITY MODEL

A maturity model is a tool that helps people assess the current effectiveness of a person or group and supports figuring out what capabilities they need to acquire next in order to improve their performance.

“Maturity is a measurement of the ability of an organization for continuous improvement in a particular discipline.”

-Wikipedia

A maturity model shows how capable an organization or system is of achieving continuous improvement.

Basically, maturity is being judged by how good your organization or system is at self-improvement.