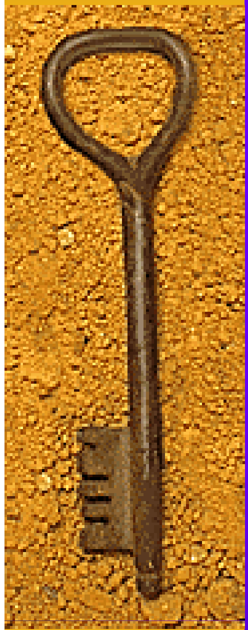
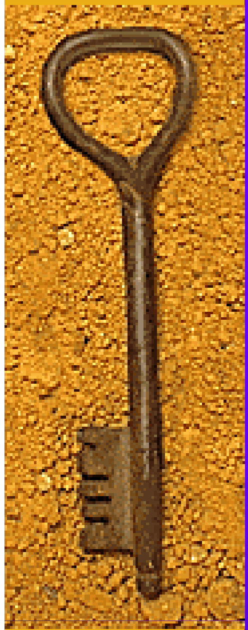


Introduction of course

Commercial Banking Management II

Prepared by Dinh, T.N. Huy

May 2012



Chapter 4

Risk Management Functions at CBs

Prepared by Dinh, T.N. Huy

June 2012

Agenda

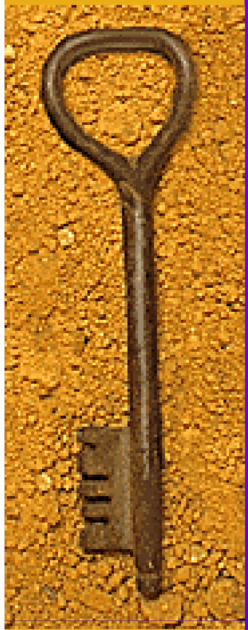
1. Overview
2. Definition
3. Why CBs need Risk management
4. Functions
5. Competitive analysis
6. Examples
7. Summary

Overview

- The longer the time a bank operates its business system, the higher the risk it manages. Therefore, a banker needs to understand:

+ Risks

+ Risk management process



Basic Concepts

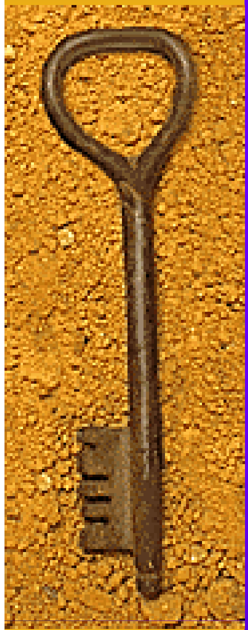
- Risk definition, generally:

  It is a potential for an activity to get losses. In business, it is components causing uncertainty about business results.

Basic Concepts

- Risk definition, ISO/IEC 73:

  It is defined as a combination of probability of an event and its consequences.



Basic Concepts

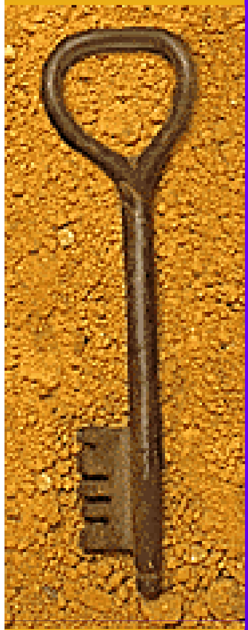
- Risk management, generally:

  It is a process to identify risks, priortize risks, evaluate, measure risks

  Because risk is a part of banking business, risk management is a part of business, also.

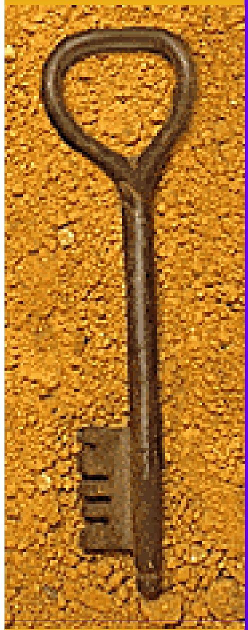
Basic Concepts

- Risk mitigation: for simplicity, it is risk reduction.
- When a bank lends a business or a project, it involves risks and the bank prefers risk mitigation



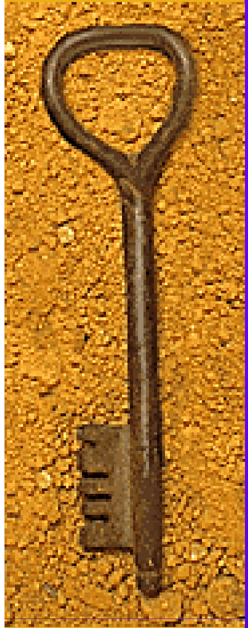
Why CBs need Risk management

- Banking is a business relating to money
- Money is affected by interest rates, exchange rates and types of investments
- All of these factors have risks. So, Risks need to be managed



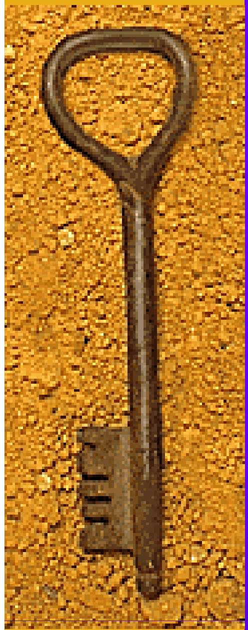
Why CBs need Risk management

- Whenever a commercial bank experienced losses, it might imply risk appearance
- The better the risk management process, the lower the losses



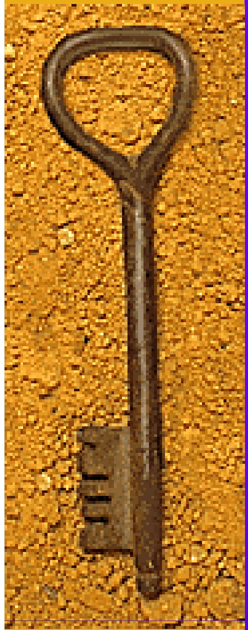
Roles of Risk management

- It is a component in the process of decision-making at CBs
- Besides, it is a part of all processes at CBs
- It creates values for CBs



Types of risk

- Legal liabilities risks
- Credit risks
- Liquidity risks
- Operational risks
- Risks from uncertainty in financial markets

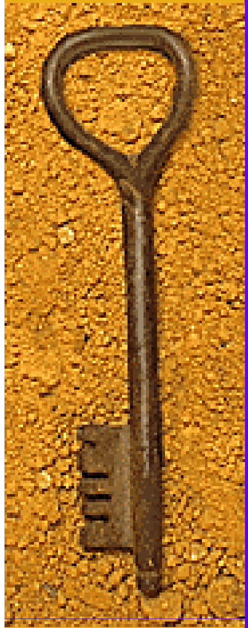


Types of risk

- Besides above listed risks, we will come back to another type of risk, that is, risks relating to banks' balance sheet
- This point will be mentioned in chapter 10

Functions of Risk management

- Protect and add value to the bank
- Can be a central component of banks' strategic management
- Increase probability of success
- Reduce probability of failures



Risk management process

- The process of risk management:

Identify or Assess risks

↓

Evaluate risks or Plan Action

↓

Manage or Monitor risks

↓

Measure or Control risks

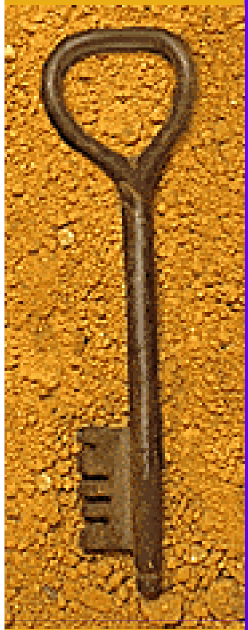
Competitive analysis

- Through making a competitive analysis, commercial banks can identify business risks
- Competitive pressures might cause potential decline in services prices and losses

Examples

- Banking business might experience financial risks including:

+ Interest rate risk
+ Foreign exchange risk
+ Credit risk



Examples

- Banking business might experience operational risks including:

+ regulation factors

+ culture factors

+ board composition

Examples

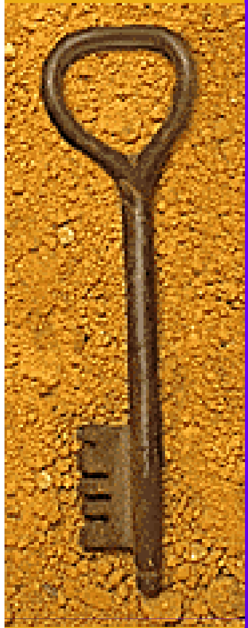
- Banking business might experience strategic risks including:

+ competition

+ customer changes and demand

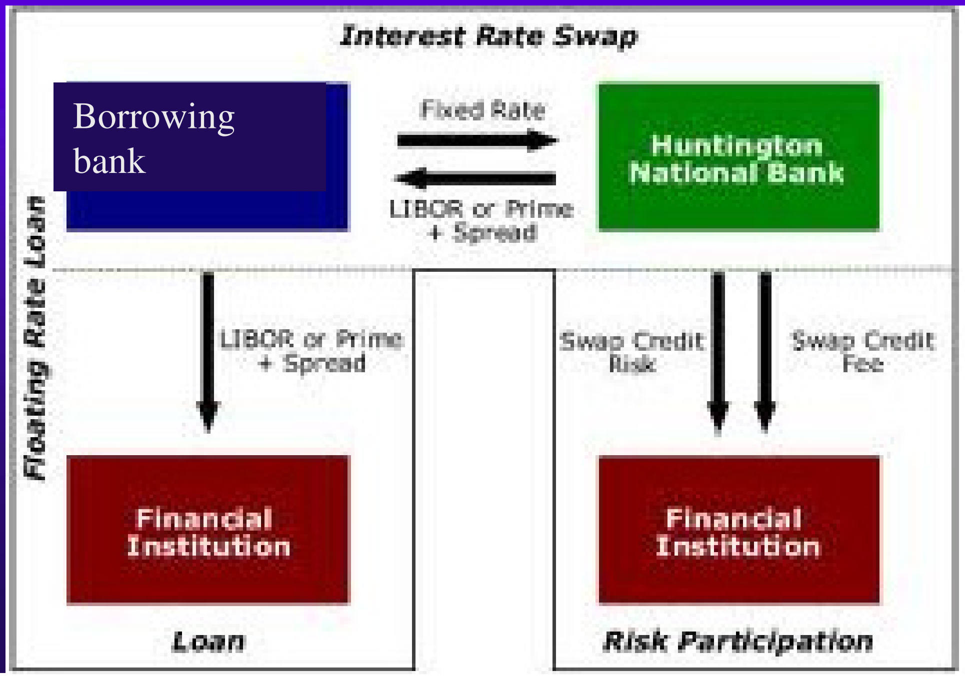
+ industry changes

Examples

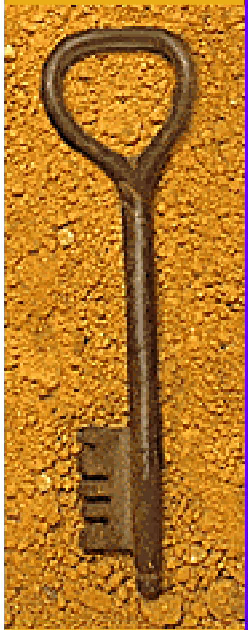


- Interest rate swap (interbank market)

This rarely, but may be used, to swap the fluctuations in floating rate for the fixed rate at a credit swap fee



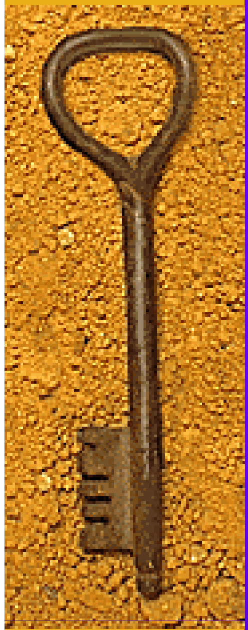
Examples



- The above diagram shows:

+ there are 2 parties (counterparties)

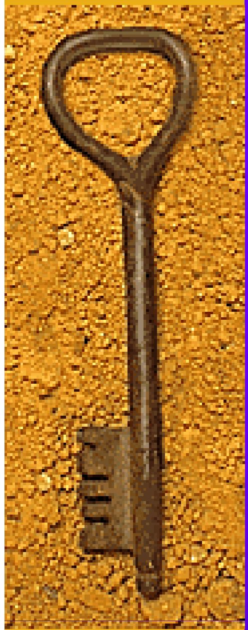
+ One future CF of interest payments is exchanged for another CF, based on principal amount



Examples

- The above diagram shows:

+ A fixed payment stream exchanged for a floating payment stream with a rate (LIBOR,…)



Risks at Vietnamese commercial banks

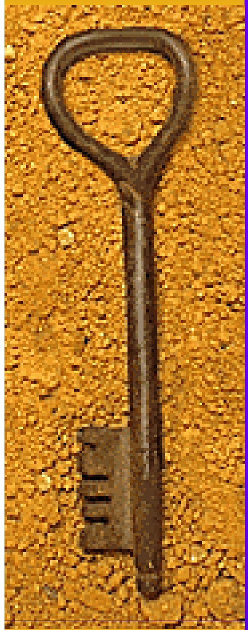
- Legal risks, Credit risks,…
- May include technological risks (Ex: using old version of ATMs is a risk because it make losses)
- Risks come from internal and external factors (crisis)

Managing Risks at Vietnamese commercial banks

- Objectives:

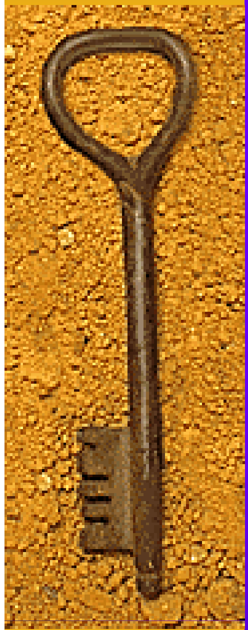
Creating and adding maximum sustainable value to a bank's operation

Supporting a more efficient resource/capital allocation in the bank



Managing Risks at Vietnamese commercial banks

- Transferring risks to another party
- Be afraid of and Avoiding risks
- Lower negative impacts of risks
- Reducing probability of risks
- Using business practices to reduce simple risks



Managing Risks at Vietnamese commercial banks

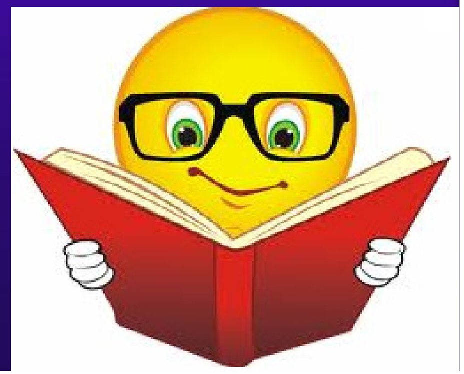
- Transferring risks to another party:

+ A commercial bank can offer a new product design with a new pricing policy.

+ Ex: By launching a new deposit type, it can increase the lending capacity; doing so helps to reduce the credit loss/lending capacity and reduce risks

Summary

- Risk management not only helps to reduce volatility of non-important areas in bank, but also reduce uncertainty in achieving business objectives
- Risk identification needs a broad knowledge of the market and competition



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Multiple Choice Question

1. Which is NOT TRUE about risks in banking:

a. It includes strategic risks
b. It includes operational risks
c. It includes financial risks
d. It does not include compliance risks
e. All

Multiple Choice Question

2. Which is TRUE about risk management:

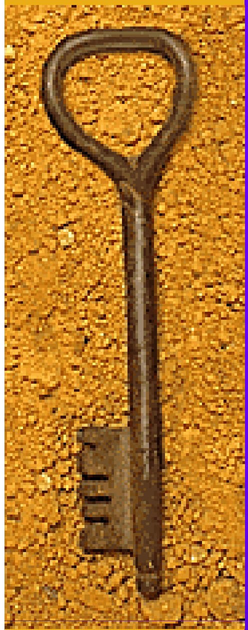
a. It helps to reduce the probability of failures

b. It increases the probability of success

c. It helps the organization to use its capital more effecient

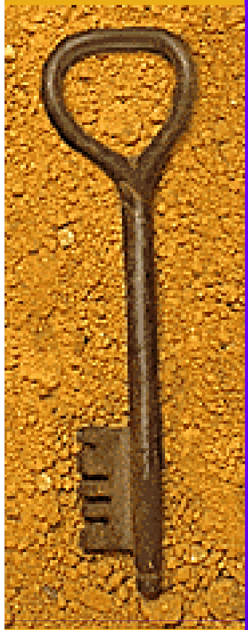
d. All

e. None



MCQ-Answers

1. D
2. D



Terminologies

Mitigate = eliminate (v)

Transfer the risk to…= shift the risk to…(v)