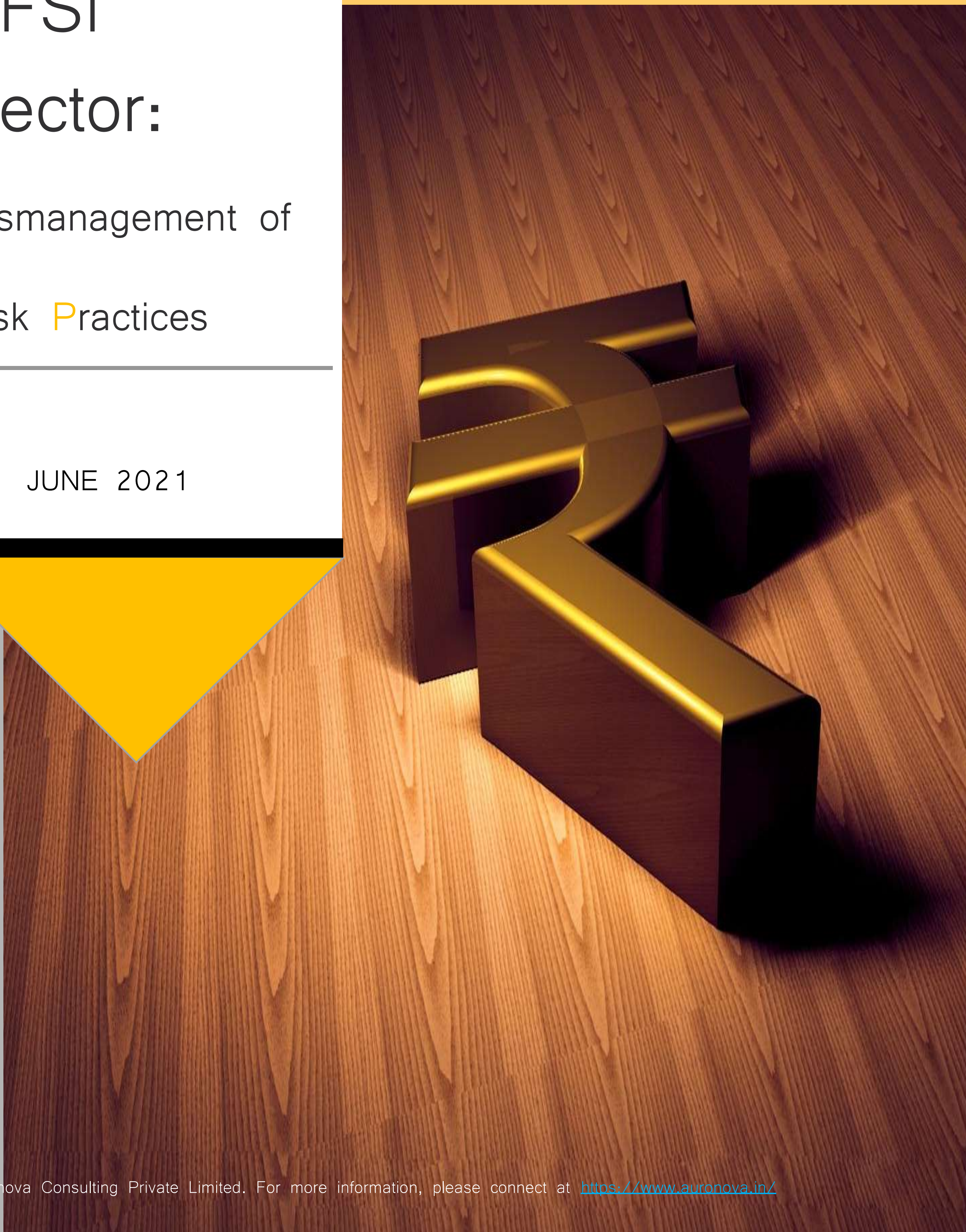
BFSI Sector:

Mismanagement of Risk Practices

JUNE 2021



The failure of Barings Bank in 1995 gave rise to a continuous series of new and changed regulations, guidelines, and processes to tackle Market risk and Risk management in general. Over the years, Basel Committee on Banking Supervision (BCBS) on its part has been trying to introduce the best practices that can be followed by banks to avoid such a debacle.

But time and again from 2008 Global Financial Crisis up till 2021, all we can see is how despite the regulators' best attempts banks are not able to implement & adhere to recommended risk management practices.

A lot of people believe the Barings Bank failure had more to do with a single individual but the truth was, it was the collective failure of the bank's Board, Senior Management, Processes, Internal controls and most importantly it's risk culture and governance.

We would imagine that a catastrophe of this magnitude would make banks more responsible and it did but only to the extent of regulatory abidance. Today, risk management has become a mandatory aspect of the banking business with various regulations to be complied with by the firms to not attract fines from the regulators. But that's where the problem lies.

Banks even today see risk management as a cost and not an investment. This attitude of viewing risk management just as a regulatory requirement and not a pre-requisite for strengthening long-term business, is what leads to undermining of recommendations by the risk department in order to favor new risky business, which if all goes well might pay off outstanding returns but if it doesn't, has the potential to threaten the ultimate closure of a bank and to put the depositors at risk.

Failure of risk management is generally attributed to lack of good talent, lack of related sophisticated risk systems & frameworks, lack of data or indecisive board management. But the real factor is bad risk culture, governance & oversight. With introduction of regulations such as Basel III, disclosures aimed at making banks more transparent in their dealings and accountable for their actions, seem to be only an on-paper exercise which is not taken in to consideration while taking on new risky businesses.

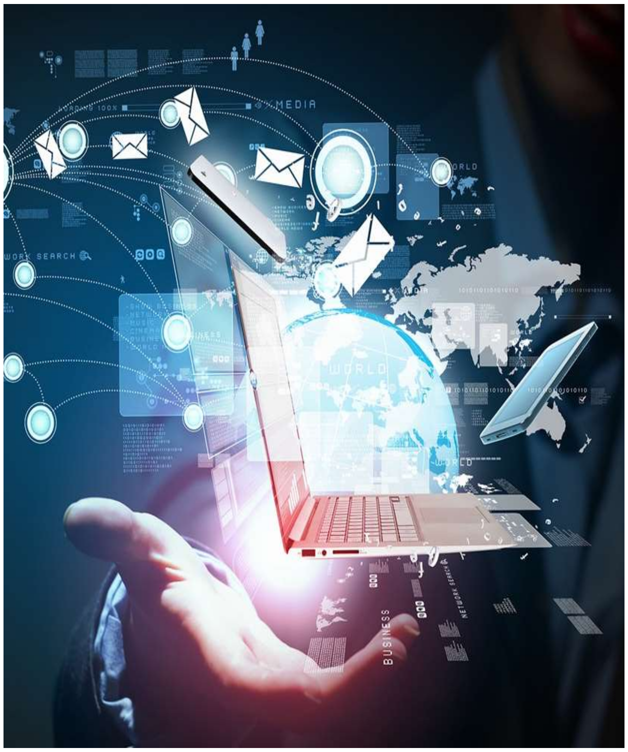
Most of the regulations and recommendations come into place after some major event such as a fraud, burst of an asset bubble etc. happen, it is imperative for the banks to proactively guard against such unforeseen events and go beyond the current gamut of regulations in place.

There have been organizations who spend over half a billion dollars every year in order to have the best risk management talent, technology and internal controls and yet incur large losses.

A major reason for this is that requisite risk related talent and processes can only help identify, detect and report the risks. Risk analysts do provide their analysis and processes like Risk and Control Self-Assessment (RCSA) if done properly can help to identify and to some level quantify potential risks. But it is up to the senior management to set-up a culture where actual business decisions get augmented by the recommendations by these departments and processes.

Time and again we have read within regulations, guidelines as well as in general business acumen that a good risk culture is set when the Senior Management & Board Members are in tandem with it. It aids in bringing about a sound risk appetite for the rest of the organization as well to follow, integrate, execute & implement within their work dimensions. But so many risk management debacles in the past year itself show us that it is easier said than done.

At the end of the day, banks are like any other business and their aim is to make profits and increase shareholder's value. In order to achieve this goal, risk taking is essential. Risk isn't something that should be avoided but something needs to be carefully managed. Given that unlike other businesses, depositors trust their banks with hard earned money and life savings there should be a fine line between calculated risks and risks based on myopic oversight.



Investing in risk practices itself is not enough to mitigate impending risks; it requires direction, understanding the advice & recommendations put forward by domain experts, assessing the newer variant of risks, their implications and their level of impact on the current & future business models.