

## Define What You Perceive as the Largest Risks Facing the International Banking System?

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### Abstract

Risk management is an activity, which incorporates acceptance of risk, risk assessment, developing strategies to manage it, and easing of risk. Several traditional risk managements are focused on risks arising from physical or legal causes (e.g. natural disasters or fires, accidents, death). Financial risk management focuses on risks that can be managed using traded financial mechanisms. The purpose of risk management is to reduce different risks to an acceptable level. The paper describes the risks international banking system faces in the current times and recommends alternatives to mitigate these.

**Keywords:** Risk management; Financial institutions; Financial mechanisms; Legal causes

### Introduction

Risk is unavoidable and present in every situation. Depending on the framework (insurance, stakeholder, technical), many accepted definitions of risk are in use. The common concept is uncertainty of outcomes. Some describe risk as having only undesirable consequences, while others are neutral. Risk refers to the uncertainty that surrounds future events and conclusions. It is the expression of the likelihood and impact of an event with the potential to influence the success of a firm [1]. It implies that some form of quantitative or qualitative analysis is required for making decisions concerning major risks or threats to the firm's success. For each risk, two calculations are required: its probability; and the extent of the impact [1].

Modern competition in the banking industry has forced many commercial banks to pursue growth in sectors that fell within the realm of other financial institutions such as investment banks, insurance companies, hedge funds and pension funds [2]. Blake D et al. [3], argued that every investment and financing decision involving the allocation of resources under uncertain conditions is associated with some risk, either in the expectation of a higher return, or transferred to others through hedging and/or contracting arrangements [2]. From a financial perspective, risk is defined as danger that a certain unpredictable contingency can occur, which generates randomness in cash flow [2].

Boltman and Tieman state that increased competition and rigorous capital adequacy requirements in the banking industry often lead to riskier bank behavior. Banks have used the deposits from their customers to fund mortgage lending activities. Choosing between making higher profits and tolerating a higher risk of failure, a bank may decide to attract more demand for loans or worsen the quality of its loan portfolio [2].

There has been series of discussions regarding the risks inherent in the conventional banks and that of Islamic banks. Conventional banks are inherently more risky than their Islamic counterparts as they have stronger balance sheets due to the extension of credit against real assets in comparison. Several financiers have argued that Islamic banks appear to be overcapitalized in comparison to conventional banks due to the presence of profit-and-loss sharing deposits in the operations of Islamic banks, says Kantakji (n.d.). The fact is that the global banking system is faced with major risks [2]. Boyd et al. [2]

found that all banks are identical in nature and exposed to the same form of risks. Therefore, failure of one bank affects the others. Risk management assists with decisions such as the costs with the benefits and expectations of investing some degree of public resources; and the governance and control structures needed to sustain due diligence, responsible risk-taking, innovation and accountability that add to the firm's success at the individual level and in serviceable areas [1].

### History of international banking

The Bretton Woods and GAIT (General Agreement on Tariffs and Trade) harmony after the Second World War provided stability in international monetary relationships and liberalization of trade and capital activities. International banking flourished as the global economy grew under liberalization. The beginning and progress of the Eurodollar market provided banks the resources to overcome local and international restrictions on their international operations, and led to a sudden increase in institutions providing services [4]. The collapse of Bretton Woods in the early 1970s, provided institutions with the instability of markets and the ready supply of funds to introduce a wide range of international banking products and services [4].

During this period, the activities of U.S. institutions in the international realm were rising. The smaller regional banks moved to the international arena as a means of maintaining their competitive stance, growing their reach, and improving their profits. Moreover, despite the unreliable references to the expected profitability of offering international services (e.g., providing credit, trade financing, or foreign currency services), the number of banks offering such services had actually declined over time. The work by Haslem et al. in a series of papers (1986, 1992, 1995), looked at the relationship of various international banking strategies and bank profitability by large money center banks. On the other hand, smaller banks have been examined for the use of financial derivatives. Brewer et al. and Carter et al., have all

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looked at how derivative use was related to overall bank performance or how it impacted bank hedging decisions [4].

## Discussion

The failure of risk models occurred in number of areas [5]: 1. The assumption that asset prices would continue to increase, ignoring possibilities of shattering asset bubbles; 2. A basic flaw in an attempt to capture social and economic issues existed; 3. The consumption of the Value-at-Risk risk measure proved to be inaccurate as it underestimated the factual risk exposures; 4. The reliance on uncertain external ratings, where ratings agencies utilized historical data models from stable periods; and 5. A given range of losses at a given magnitude was assumed. An analyst indicated that risk and valuation models, were deeply flawed at the very core of asset markets, assuming that a 3.5 standard deviation contains nearly 100% probabilities, but many events went beyond that limit [5].

Sovereign Funding and associated credit risks have continued to impact upon global financial stability due to the financial crisis. Instability has increased aiming at shoring up massive sovereign debts within Greece, Portugal, Italy, Spain and Ireland [5]. This has seen enormous pressure targeted towards these countries (Greece) to accept a range of remedies [5]. For instance, in 2011, Germany approved to be a part of the joint €440bn for the European Financial Stability Facility (EFSF), to purchase bonds and offer loans to distressed EU member nations. However, 40-50% of the debt is due for refinancing over the next few years by Germany banks, therefore placing increased pressure of limited funding sources [5]. Government bonds are considered as riskier assets such as corporate bonds and securitized products IMF 2011. The domestic bank shares of public debt has increased, within Greece, where such proceedings have the potential to affect debt flows, deteriorating balance sheets and triggering further asset repricing (IMF, 2011). In total, the upward repricing of sovereign credit risk in government funding markets emerges as a key risk to universal financial stability [6].

## Challenges for Investment Banks in 2015

### Regulation

The pressure on investment banks from controllers, government personnels and the news channels across all markets has not eased up and continues to identify industry threats [6]. Regulation is wide in range and a game changer as banks are seeking to balance execution of the required rules and planning for those in the pipeline; but it's time to recognize the opportunities as well as the threats that exist [6]. This area achieves business success through reform by embracing regulation, allocates optimally at the heart of the business by managing collateral, and attracts new talent and retains experienced via forced compensation [6].

### Restructuring

Existing investment banking business models are not offering an acceptable level of return to investors as the governance structures, processing and the technology landscape are complex and resistant to change [6]. Extensive restructuring is required to simplify these areas by rationalizing and decommissioning process and technology, exploit opportunities via centralization and prepare banks for expansion in new locations or with new products [6].

### Revolution

New business opportunities have been sought by the investment

banks to create new client experience via digital technology, leverages data explosion for business optimization via insightful analytics, and creates a role in the fabric of the industry via utilities [6].

## Challenges for Central Banks

### Reputational risk

It is defined as a mismatch between public perceptions and the actual objectives and resources of the Central Bank. This is the most important asset and difficult risk to manage during the times of crisis. It can also arise should there be a failure to manage other risks like staff ethics and misbehavior, portfolio risks like interest rates, exchange rates, and transactional processes and IT systems. Banks are integrating risk management framework to ensure consistency across all levels [7].

### Accounting framework challenges and harmonization

Central banks are required to comply with their respective nation's equivalent Act, whose role is to manage monetary policy, control inflation, facilitate payment systems, and supervise commercial and investment banks. Banking institutions adopt GAAP or develop their own rules to accommodate their country circumstances. However, external auditors might face difficulties incase banks have their own rules. The financial crisis of 2008 led banks to harmonize their accounting principles globally by adopting IFRS, which may create other challenges for bank management and stakeholders [7].

### Valuation challenges

The financial crisis led to lack of clarity in the accounting statements and made price transactions in the market very difficult. Valuation has always been challenging for the central banks. The financial models are created based on assumptions using the past trends instead of present scenarios, which lead to greater than before sensitivity to systemic failure, and greater risk of recession. Rescue packages have been created to overcome this model risk [7].

### Managing currency in circulation

It is challenging to design control procedures that can provide reasonable assurances to the Central bank, management, central committees, stakeholders, and external auditors to the completeness of this liability (accumulation of currencies issued into circulation less those withdrawn from circulation) as no third party assurance is possible. To reflect currency circulation precisely, banks should implement controls similar to inventory controls in a manufacturing firm [7].

### Confidentiality versus transparency

Transparency permits everyone to make judgements about the integrity and stability of a nation's financial system. Lack of information can endanger the economic cycle. However, certain information like credit worthiness of the borrowers need not be disclosed and hence, applies confidentiality. The balance between confidentiality and transparency presents a significant challenge in appropriate revelation by the Central Bank. Publishing audited financial statements of banks, maintains public peace and trust in the banking institution [7].

### Governance, risk management and compliance functions

Governance in central banks can cause price instability, and jeopardize political independence. The expansion of central bank operations has increased exposures to risk such as counter party risk, market risk, credit risk, and foreign exchange risk [7]. To minimize risks,

risk management strategies are implemented. Basel III implementation is on its way to correct the weakness, which possessed in Basel II.

## Conclusion

The paper looked at the hazards the international banking system faces (central banks and investment banks), and analyzed the impact of these hazards on banking operations as well as measures used to control them. The paper found that the lack of leverage and efficiency in banking operations can pose various risks to banks globally. While every bank is faced by one type of risk or the other, they differ greatly in their risk exposures; and their exposures may or may not be closely related. Assumptions made by banks concerning their reinvestment behavior and capital structure tend to increase or decrease systematic risk. With the growing use of collateral to reduce counterparty risk, banks may become more vulnerable to liquidity pressures and legal risk. Increasing levels of risks in the international banking industry, such as systemic risk, call for greater collaboration among banking supervisors to ensure prudent monitoring, risk management and crisis management (Basel III implementation in the future). Discreet banking supervision is crucial for addressing the threat of systemic risk in today's global banking system [2].

## Recommendations

Risk-management strategies are guided by a firm's risk appetite; such as profitability and safety goals. There is a trade-off between profitability in times of normal operations and flexibility in the face of negative events affecting the firm.

Risk management and monitoring strategies include: Mitigation measures-Actions taken by the firm to reduce the likelihood and/or consequences of a negative event World Economic Forum [8]; Accountability measures-Finding ways to incentivize individual employees not to cut corners in ways that would normally be undetectable but would increase a firm's vulnerability in a crisis, such as failing to maintain backups [9-11]. Some firms hire external consultants to assess how effectively they are mitigating risks identified as priorities World Economic Forum [8]; Supply-chain diversification-Another hedge against sudden unavailability of inputs is to maintain an excess inventory of finished products World Economic Forum [8]; Avoiding less profitable risks - Firms may decide to drop activities altogether if they represent a small part of their overall business but

a significant part of their risk profile World Economic Forum [8]; Transferring the risk - In addition to the range of insurance products available - liability, property, business interruption - some large firms run their own "captive" insurance companies to distribute risks across their own different operations and subsidiaries World Economic Forum [8]; Retaining the risk - When insurance is unobtainable or not cost-effective, firms can choose to set aside reserves to cover possible losses from low-probability risks World Economic Forum [8]; Early warning systems-Some firms employ their own teams to scan for specific risks that may be brewing, from political crises World Economic Forum [8]; and Back-up sites-Many firms are set up so that if one or more factory or office becomes unusable, others are quickly able to assume the same functions World Economic Forum [8].

Crisis-management plans identify who will be the most relevant decision-makers in a crisis. In crises that are severe and span international boundaries, the chief executive officer and the board of directors are often involved. A growing number of firms have developed a general crisis plan to address unforeseen risks that complement specific plans for dealing with risks World Economic Forum [8].

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