CHAPTER III

RISK RETURN MANAGEMENT IN BANKS
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CHAPTER 3

RISK RETURN MANAGEMENT IN BANKS

The present chapter analyses the nature of risk return management in banks. The prime objective of financial management is to maximise the value of the bank which is possible only when well balanced financial decisions are taken. The management should try to maximise the average profit and minimise the risk. A finance manager has to maintain the profitability and liquidity of the bank keeping in view the over all objective of the bank. Banks essentially encounter three major risks, namely credit risk, operational risk and market risk. For prudent management with high degree of transparency, banks need to put in place a scientific system of measuring and managing risk. Better risk management has resulted in the resilience of the global financial system in recent years.
3.1 Risk Statement

Risk is an estimate that can be made about the degree of happening of the loss. Banks usually estimate it by assigning probabilities to the risk on the basis of past data and the probable trends. In short it is the chance of future loss that can be foreseen.

Fig. F 13: Risk Statement

From Fig-F 13 it is clear that all the banks defined the risk in relation to their extent. There are valid calculations to tackle the risk situation. It is revealed in the study that all the banks are able to foresee the chance of future loss.
3.2 Uncertainty Statement

Uncertainty is the unforeseen chance for future loss or damages. If the banks cannot anticipate the future loss it cannot directly deal with it in its planning process.

The study reveals that all the banks defined the term uncertainty to their extent (Fig-F 14). Therefore, it is concluded that all the banks give equal importance to the term uncertainty.

Fig. F 14: Uncertainty Statement
3.3 Types of Risks in Day-to-Day Financial Management Activities

Banks, being highly leveraged financial institutions that essentially thrive on public thrust, encounter many risks. Systematic disturbances could essentially arise and spread within the banking sector, thus exposing the bank to the systematic risk, adversely affecting not only bank lending but also financial markets and market infrastructure like payment and settlement system. From the discussions with the top management officials it is clear that the banks have evolved an integrated approach for management of risks comprising credit, market and operational risks. All the banks have evolved a road map to move towards implementation of Basel II, as per the Reserve bank of India directions.

![Risk in Day-to-Day Financial Management Activities](image)

**Fig. F 15:** Risk in Day-to Day Financial Management Activities

The study reveals that all the banks came across the credit risk, operational and market risk equally (Fig-F 15). Therefore, it is
concluded that all the four banks are aware about the three risks and follow the directions of the RBI.

### 3.4 Methods of Risk Management

There is no escape from the risk for a banking business as the risk is inherent. The banks can face this problem with greater confidence if they adopt a scientific approach in dealing with the risk. Risk management is the adoption of a scientific approach to the problem dealing with risk faced by the banking business.

![Fig. F 16: Methods of Risk Management](chart)

The study reveals that The Dhanalakshmi Bank adopted only prevention of risk as the method of risk management. But The Federal Bank and The South Indian bank includes avoidance of risk, prevention of risk and retention of risk as the methods for risk management. The Catholic
Syrian Bank considers only two methods of risk management such as avoidance of risk and prevention of risk (Fig-F 16).

3.5 Techniques Employed in the Methods of Risk Management

The banks have been following an integrated approach of risk management in tune with the business requirements. The policy documents evolved and reviewed capture the details on strategy, systems and processes the banks have for managing the identified risk class viz., credit risk, market risk and operational risk on a continuous basis. The banks are set to adopt the mandated minimum requirements in its course for implementation of Basel II as per the Reserve bank of India directions.

Fig. F 17: Techniques Employed in the Methods of Risk Management
The study reveals that all the banks have constituted risk management committees as required by the guidelines of the Reserve Bank of India. The banks have Risk Management Policy in place and adopt a pro-active approach to risk management across all risk areas. A comprehensive Risk Management system covering identification, measurement and monitoring of risks across Credit, Market and Operational risks have been established (Fig-F 17).

3.6 Criteria for Evaluating Proposals to Minimize Risk

Banks are aware that a project giving higher rate of return involves a higher degree of risk. While selecting a project, banks have to keep in mind its capacity to bear the risk. It is, therefore, necessary for a bank to select or reject a project on the basis of risk involved.

The criteria for evaluating proposals to minimize risk by the banks are mainly by selecting the least risky proposals and apply hurdle rates.

Fig. F 18: Criteria for Evaluating Proposals to Minimise Risk
In the study it is clear that The Dhanalakshmi Bank applies only hurdle rates as the criterion for evaluating proposals to minimize risk. The Federal Bank uses two criteria for evaluating proposals to minimize risk. The other two banks select only the least risky proposals to minimize risk (Fig-F 18).

### 3.7 Return Statement

One of the important functions of the Finance Manager is to measure the return which the banking business earns on account of its operations. The return represents the benefits derived by the banks from its operations.

![Fig. F 19: Return Statement](image)

The study reveals that all the banks give equal importance for the definition of return (Fig-F 19).
3.8 Approach Adopted for the Measurement of Return

One of the important functions of the finance manager is to measure the return which the banks earn on account of its operations. There are different approaches for the measurement of return, of which, the approaches followed by the banks are Income approach, Cash flow approach and Ratios approach.

![Bar chart showing the percentage of approaches used by different banks]

**Fig. F 20:** Approach for the Measurement of Return

The study reveals that The Catholic Syrian bank and The Dhanalakshmi Bank use only the Income approach. But The South Indian Bank applies two approaches for the measurement of return. In the case of The Federal Bank they consider three approaches for the measurement of return (Fig-F 20).
3.9 Components in the Rate of Return

The rate of return required by the banks, to a great extent, depends upon the risk involved. The higher the risk, the greater is the return expected by the bank. The rate of return required by the bank consists of three components namely return at zero risk, premium for business risk and premium for financial risk.

![Components in the Rate of Return](image)

**Fig. F 21:** Components in the Rate of Return

The Figure indicates that all the banks have the three components in the rate of return (Fig-F 21).

3.10 Major Risk Return Decision Areas

The banks have a direct relation ship between risk and return. A Finance Manager has to choose between risk and return in every area of financial
management without endangering the liquidity of the firm. The major
decision areas linked to risk and return can be identified as financial
analysis and control, budgeting and profit planning, capital budgeting,
financial planning, working capital management, cost of capital and
acquisitions.

**Fig. F 22: Major Risk Decision Areas**

The study reveals that only The Federal Bank has adopted all the above
decisions linked to risk and return. But in the case of The Catholic
Syrian Bank and The South Indian Bank the researcher has identified
only three decision areas linked to risk and return (Fig-F 22).