CHAPTER - 5

VARIOUS RISKS FACED BY PSU BANKS

5.1 **Credit Risk**

PSU Banks nowadays are exposed to a number of risks. The major risk which the PSU Banks face is the credit risk.

Credit Risk is the potential of a bank borrower or counter-party to fail to meet its obligations in accordance with agreed terms. For the PSU banks in India, loans are the largest and most obvious source of credit risk and consequently, for PSU Banks in India credit risk is the most crucial risk. Efficient management of the credit risk is critical for the success of the PSU Banks.

5.2 **Government Ownership: Is it a credit risk?**

The assumption in case of PSU banks is that government has adequate information and incentives to promote socially desirable investments and in extreme cases can transfer the depositors’ loss to tax payers. Government ownership of banks in India has, however, at
times, promoted financing of politically attractive projects and not the economically efficient ones. From the PSU banks’ management perspective this is a kind of credit risk that at times appears to be beyond their control.

5.3 Other Risks Faced by PSU Banks

Apart from credit risk PSU banks also face a number of other risks which are briefly described hereunder:

5.3.1 Liquidity Risk

Market Liquidity Risk arises when a bank is unable to conclude a large transaction in a particular instrument near the current market price. Funding Liquidity Risk is defined as the inability to obtain funds to meet cash flow obligations. For banks, funding liquidity risk is more crucial.

5.3.2 Interest Rate Risk

Interest Rate Risk (IRR) is the exposure of a Bank’s financial condition to adverse movements in interest rates. Banks have an appetite for this risk and use it to earn returns.
5.3.3 Pricing Risk

Pricing Risk is the risk to the bank’s financial condition resulting from adverse movements in the level or volatility of the market prices of interest rate instruments, equities, commodities and currencies. Pricing Risk is usually measured as the potential gain/loss in a position/portfolio that is associated with a price movement of a given probability over a specified time horizon. This measure is typically known as value-at-risk (VAR).

5.3.4 Foreign Currency Risk

Foreign Currency Risk is pricing risk associated with foreign currency.

5.3.5 Market Risk

The term Market Risk applies to (i) that part of IRR which affects the price of interest rate instruments, (ii) Pricing Risk for all other assets/portfolio that are held in the trading book of the bank and (iii) Foreign Currency Risk.

"The trading book means the bank's proprietary positions in financial instruments which are intentionally held for short-term resale and/or
which are taken on by the bank with the intention of benefiting in the short-term from actual and/or expected differences between their buying and selling prices, or from other price or interest-rate variations, and positions in financial instruments arising from matched principal brokering and market making, or positions taken in order to hedge other elements of the trading book.” (Basel 1996)

5.3.6 Strategic Risk

Strategic Risk is the risk arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organization’s strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation.

5.3.7 Reputation Risk

Reputation risk is the risk arising from negative public opinion. This risk may expose the institution to litigation, financial loss, or a decline in customer base
5.3.8 Transaction Risk

Transaction risk is the risk arising from fraud, both internal & external, failed business processes and the inability to maintain business continuity and manage information.

5.3.9 Compliance Risk

Compliance risk is the risk of legal or regulatory sanctions, financial loss or reputation loss that a bank may suffer as a result of its failure to comply with any or all of the applicable laws, regulations, codes of conduct and standards of good practice. It is also called integrity risk since a bank’s reputation is closely linked to its adherence to principles of integrity and fair dealing.

5.3.10 Operational Risk

The term Operational Risk includes both compliance risk and transaction risk but excludes strategic risk and reputation risk.

5.4 Inter-dependence of PSU Banks in India: An Added Risk

PSU Banks have to worry about not only about their own failure but also failure of any other PSU bank in India. A bank fails economically
when the market value of its assets declines below the market value of its liabilities, so that the market value of its capital (net worth) becomes negative. At such times, the bank cannot expect to pay all of its depositors in full and on time. There is a risk that the failure of one PSU bank may spill over to other PSU banks and possibly even beyond the banking system to the financial system as a whole, to the domestic macro economy, and to other countries. Banks indulge in continuous lending and borrowing, to and from each other, and need to pay other banks for third-party transfers, and therefore, tend to be very tightly financially interconnected with each other. Thus, PSU Banks are particularly inter-dependent and shocks at any one bank are viewed as likely to be quickly transmitted to other PSU Banks, which in turn can transmit the shock to the corresponding chain of banks.