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Potential Risks for the Banking Sector and How to Avoid Them

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Abstract

The aim of this article is to access the identify the Potential risks for the banking sector and how to avoid them, to enhance the risk management and profitability of the firm. The analysis of the historical banking crises and how the crisis could have been prevented or mitigated with better risk management strategies. This research paper also surveyed the different techniques adjusted by banking industry for risk management. The article and case studies data have been collected from the secondary sources i.e., from Books, various publications available online, and journals. recognized different risks faced by the banks, developed the process of risk management and identified different risk management techniques. This article has also shed the light on the Technological Solutions for Risk Management.

Keywords: *Potential risks, banking sector, risk management.*

Introduction

Bank is a financial instrument that performs the primary functions of accepting deposits and creating the demand deposits and also advancing the loan payments. The banking sector has a greater role in the financial stability of the country as well as the economy of that country.

Banks are important for the development and growth of the economy. Banks act as the intermediary between the lender and the borrower by providing them secure and safe channel. Banks encourage savings. Bank issue money in the form of currency notes. Banks act as both paying agents as well as the collecting agent. Banks lend money to private loans as well as commercial loans thus improving the credit quality. Banks also created money by issuing it and also destroy the money by repaying the loans thus maintaining the liquidity of the money in the economy.

Significance of addressing these risks

The understanding of the risk to the banking sector is crucial because Due to the expansion of the banking sector into the economy, indicates it is impacting millions of people. Exposure of the banking sector to risks can cause banking failure, ultimately leading to the Great Financial Crisis one of the 2007–2008 financial crises. By understanding the potential risk in the banking sector, Governments can set improved regulations to stress better management and decision-making. The risks can lower the benefits and increase the losses and adverse selection and affects the investors. For valuable investments, banks require to keep their potential risk lower, to avoid losing

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money. The over-exposure to these risks can lead the banks to Liquidity risk. The potential legal risk to the banking sector is the Basel II, which entails their activities and exploitation of the opportunities. The Market risk arises due to the capital market, Operational risks which are caused by the sales and trading activities of the banking sector. One of the biggest risks for banks is credit risk, which arises when the borrowers fail to meet the contractual agreements. On a larger scale, fraud can occur through breaching the cybersecurity of the bank by the hacker thus stealing the money. Addressing the risk means addressing the financial stability of the bank, along with Addressing the financial crises to avoid losses. Which is important for the longer-term viability of the banking business and customer satisfaction. Prudent risk management can help banks to enhance their profits as they sustain little losses on loans and investments. (Liubkina et al, 2019)

Explanation of Risks

Credit Risk

It is the biggest risk for the bank. When borrowers fail to meet the contractual obligation. Borrowers may fail due to several reasons like default on the interest payment of the loan because of the default, which may occur on mortgages or cards of credit. The model of the banking business is complex and cannot be fully protected, so risk exposures can be lowered. Diversification can assist in lowering credit risk. They can loan to people with histories of good credit or back up the loans with collaterals. (Gadzo et al, 2019)

Operational Risk

This Risk is due to the operational errors, and damages caused by the people or the system of the bank. Retail banking and asset management have lower operational risk. Sales and trading have a higher operational risk. Mistakes or fraud made by the teller can cause human error loss. Banking cybersecurity breaches are also a kind of fraud for instance by hackers. This operational risk can cause damage to the bank's reputation, investors will lose confidence and will not deposit in the bank in the future. (Orichom & Omeke, 2021)

Market Risk

This kind of risk is mostly attributed to the activities of the bank in the capital market because the capital market if they are more involved in the investing, has high unpredictability and volatility. Interest rate fluctuations and Inflation can expose the banks to market risk. The contingent change in the demand and supply of commodities makes it harder to predict and put turns investment into the risker. The diversification of the investment portfolio can address the market risk partially, not completely due to its model of the working of the business.

Liquidity Risk: -

This liquidity risk arises due to the mismanagement of the asset and liabilities. When short-term liabilities are surplus the short-term assets can cause the bank to lose confidence. This can cause further worsening leading to Bank Run and Snowball effects.

The liquidity risk can be lessened through the existing regulations which make it mandatory for the banks to hold enough liquid assets to survive and meet the demand deposits of the customers.

Digital and Fintech Risks: -

As technology reshapes banking, regulations must adapt to address new risks such as cybersecurity threats, data privacy concerns, and the emergence of fintech startups. Regulatory sandboxes allow experimentation within a controlled environment to foster innovation while managing risks. (Ekinci & Poyraz, 2019)

Emerging Risks

The reliance of the financial markets on technology has made the system more independent. A complex cloud system has created a critical infrastructure that is outside the bank's control and beyond the regulatory scrutiny of the regulator. Thus, exposing it to the "cybercrime attacks". Cybercrime is not well understood and evolves rapidly, the digitization of the industry can hold them to manipulate the financial system. New partnerships are important between banks, law enforcement, government, and technology firms to detect patterns of cybercrime; and most importantly to disrupt the infrastructure used by those criminals' groups. Customer data is a crucial area of emerging risk, increasing both in value and the potential for misuse. Data breaches have taken center stage in recent months, with Facebook and British Airways among the highest-profile and highest-impact attacks. (Arner et al, 2020)

The emerging societal risk is that fast responses are needed, there is also an increase in the transparency and possible threats of Automation, keeping the insights that are lost to automation, skills, and employment for instance banks will be obliged to reskill the unemployed

Historical examples of banking sector crises and their causes. (World Bank, 2019)

The Great Depression (1929-1933)

Its cause is the crash of the stock market in 1929, which set off a severe downturn in the economy. It exposed the fragility of the banking sector, Such as the irregularities, high level of borrowing by the individuals and the banks, and other speculations. The bank run was caused by the excessive demand for money leading to insufficient liquidity. (Baron et al, 2021)

Savings and Loan Crisis (1980s-1990s)

Its causes are the risky lending done by the lending and saving institutions due to their loose regulations and irresponsibility. The speculative risky investment was made into the projects of real estate and there was no proper management of the risk. This led to the insolvency of many banks and government bailouts to save the complete collapse. (Baron et al, 2021)

Asian Financial Crisis (1997-1998)

The cause of the Asian Crises was the weakness of the financial system, activities like borrowings, and speculations of the currency. The devaluation of the currency was out of the control of the government causing serious trouble for the economy. Uncurbed borrowings in foreign currencies and lending practices exposed the banking sector.

Global Financial Crisis (2007-2008)

The GFC was caused by Predatory Subprime mortgage lending practices. The contribution of the risky loan cauterization and complex products of finances led to massive losses. The primary reason was the collapse of the Housing market. The impact spread across the whole economy caused the shortage of liquidity, Recessions in the economy, and failures of the bank (Bagaev et al, 2022)

European Sovereign Debt Crisis (2010s)

The cause was fiscal discipline was weak, Surplus debts of the Government affected some banking sectors hardly, Eurozone was not properly integrated. Fear to default led to the volatility of the market and instability in the banking sector.

Banking Crisis in Iceland (2008-2009)

The Icelandic banks were exposed to rapid expansion greater than the economy of the country, which was further fueled by the practices of risky borrowings and lending practices that led to crises. Global financial crises seized the market. With resulted in liquidity crises and the collapse of Icelandic banks. (Carney, 2019)

Banking Crisis in Cyprus (2013)

The Sector of banking in Cyprus was also featured by loose regulation and risky practices lending. When the Greek debt crisis soared, the Cyprus banking sector tolerated massive losses, and depositor confidence disintegrated. Subjection to Greek government bonds and the Greek sovereign debt crisis had a significant impact on Cypriot banks.

Regulatory frameworks.

The three Basel I, Basel II, and Basel III frameworks, these Basel frameworks provide the standard for the adequacy of the capital and also the management of the risk. The requisites of Basel III are stricter for the liquidity and leverage Ratio and Capital Reserves. By using this measure, the capability of the bank is improved to deal with losses during the financial downturn   Stress testing recognizes vulnerabilities and checks banks have sufficient capital and liquidity to survive unfavourable conditions. The activities of the banks are regulated using certain regulations it is a kind of call for separation, to stop them from taking excessive risks. The Volker Rule prevents the banks from proprietary trading and their investments are limited to hedge funds and private equity funds. Larger banks are designated as the SIFIs due to their potential impact on the whole financial system, if they Failed, they are regulated by the regulatory bodies. These institutions face higher regulatory scrutiny and are essential to hold additional capital as a buffer against systemic risks.

Regulatory Measures and Supervision

Bank regulations are written rules that show the defined behaviors and conduct of the Institute of Finance. There are approaches to supervision, "Command and control", management-based and performance-based. Different approaches are used for the different types of the industry. Recently, there is the frequent debate on the type of regulation, the most suitable will be depending on the sector of the economy. The complex area has the approaches in the mixture. Efforts to adopt the performance-based regulation are growing but Command and control regulation still prevail. Simultaneously management-based regulation is being considered by many agencies of regulation to cope with the modern economic and social system complexities. management-based regulation has seen increases in safety and productivity. (Anginer et al, 2019)

In the supervisor approach to the transaction, the sole entities are supervised according to the capital requirement of the respective regulators. Consolidated supervision is associated with the process of supervision satisfied with the health of the entire group's activities. The changing financial landscape requires more robust tools and goals to mitigate the risk raised due to the dynamism of the global environment is known as Risk Based Supervision. (Danisman & Demirel, 2019)

Technological Solutions for Risk Management

The end-to-end user monitoring data and assessment should be made sure and it is essential for the entire organization system. (Laeven & Valencia, 2020)

The identification of the harmful situations and the risks is the prime step in creating such a step. Company operations, sensitive data, and evaluating systems start with the IT risk assessment.

The data exposure has possible outcomes and information shared should be explored, examining the third-party entities, vendors, and also the computer and cell phones of the employee. To protect the organization the recommended safeguard is a program called Vendor Risk Management (VRM). (Jaksic & Marinc, 2019)

Monitoring is not about setting the procedures and walking away, that is not enough, regarding monitoring. You need to monitor continuously.

Risks are prone to increase and decrease over time. The monitor system should be capable to a accept and adjust this change in risk. The discovery of the new evolving risk can be possible by surveying the trends in the industry, Vulnerabilities of the software, and operations of the vendor and corporation. (Königstorfer & Thalmann, 2020)

If the passwords are leaked and data is stolen is what that triggers the response at the tech risk of your company and its mitigation is triggered by the predefined event or the status change. This kind of trigger is assessed when there is a risk assessment. The studies show that seventy-five percent of threats were result of the internal threats, and others were, so it is recommended to scrutinize the internal threats. To counter the internal threats what monitoring system do you have? What the developed triggers what do you do for identifying the malicious activities and how backup systems and data are monitored? (Saeidi et al, 2019)

The establishment of the thresholds for the changing procedures when a risk increases.as well.

The key player in shaping the future of the banking sector is the Artificial Intelligence, Big data Analytics, Cybersecurity, banking at the fingertips, and last but not least blockchain technology. The concept of Digital currency is one of the main challenges in the future for the banking industry. Digital technology is already rampant in to the banking sector with the innovations further pushing it to the edge in Digitalization in the future. The threats of hackers and cybersecurity are also inevitable but they can be mitigated or reduced by effective cyber security in the industry. Most customers prefer the easy online payment system, so the traditional way of the banking sector is only limited to third-world countries and operation at a very low rate in developed countries. Online banking services are no doubt can be easily prone to the hacker if they accessed the pin of the stakeholder, they can manipulate the account stakeholder. Can also pose a great financial loss to the stakeholder of the banking industry.

Case Study: - JP Morgan Chase & Co. (Financial Crises 2008)

During the financial crises of 2008, JP Morgan was managed better than other but was not entirely unharmed. During the crise it faced the challenges related to the Collateralized debt Obligation (CDOs) and mortgage-backed securities. (Bernier, 2022) The loss of $2 billion was faced by the JP Morgan during the financial and economic downturn. The US Government backed (TARP) Troubled Asset Relief Program bailed out the JP Morgan firm $25 billion, which assisted JPMorgan to buy failing investment bank Bear Stearns for $1.4 billion. JPMorgan weathered the 2008 financial crisis better than most during the Great Financial Crises, the most of resilience were due to its conservative practices of the risk assessment, Business model of the Diversification and Bank was also cautious to the risky assets like mortgage-backed securities. (Hearit, 2018)

The Mitigation of the Crises Strategies: -(Dashottar & Srivastav, 2021)

- The Risk management was enhanced by proper diligence and preventing the exposure to the risky assets, like the JP Morgan Conservative practices helped it to stand out in during the financial crises. Adherence to the prudential standards can help the bank to identify the Potential Risks.

- Diversification is also one strategy, by which firm diversify its revenue streams, mutual portfolios are less risky as compared to the single revenue streams. Regularly Stress testing can help the bank to find the vulnerabilities.

- The Risk awareness and accountability should be fostered throughout the firm. Transparency in the firm can help to mitigate the potential risk in the firm. Sufficient reserves of the Capital should be maintained to not let the stability of the firm to the economic downturns.

Conclusion

In conclusion, the banking sector is working in a complicated web of challenges, as is clear from the above literature on potential risk and risk management. The literature has shed light on the different types of banking risks, from the market, credit to systematic and operational. The evolving risk is getting emerged due to volatility of the financial markets, technological advancements, and discrepancies in the landscape of the regulation. The emerging risks and disruptions are not new to the banking industry because they are focal points for this industry. The uncertainties of digitalization and threats of the cyber have already intricated the risk management framework. This has made the imperative for the banking industry to cope with this challenge effectively.

The strategies to mitigate this risk are by the different span of approaches. Diversification of assets, stress testing, robust internal controls, and effective corporate governance are fundamental practices that help to build resilience against various risks. Due to the threat of the risk to the whole industry so they make efforts to collaborate to enhance their capacity to manage this risk.

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