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Risk Reporting in case of Banks: Listing down Qualitative and Quantitative Parameters

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Abstract: *Banks are the backbone of financial system. Banks perform their business through deposits of customers and advances to borrowers. Risk is the underlying aspect of business of banks because of very nature of its business. The business of banks depends upon the confidence and trust of stakeholders. Trust is built through transparency and disclosures are the main base of creating transparency. This paper is related to one of the crucial aspect of reporting practices of banks which are risk related reporting. The various part of the paper concentrates upon concept of risk, different sources of risk and then elaborate the concept of risk reporting and parameters of risk reporting in case of banks.*

Introduction

Financial system is the backbone of any economy and banks are primary participant of financial system. Banks today not only drives economic growth but also leads towards social transformation. Public disclosures play an important role for any entity having various categories of stakeholders. More disclosures are helpful in reducing information gap between the group who is having abundance of assess on the information and the other who can assess little information (Global Assessment of Banks Disclosure Practices 2006). Public disclosures are also very important for financial institutions like banks but till date have not received proper attention in case of banks. Banks provide a great amount of information which is helpful in decision making by shareholders. However there is usually calls from different classes of stakeholders for even more amount of information (Linsley and Shrives 2005). Banks collect deposits of small savers and utilize them for risky investments or loans which involve risk. Banks must have sufficient amount of capital to cover the risk arising from the investment in risky assets to ensure solvency position. Most of the banks are engaged in excessive risk taking as the solvency targets may not take into consideration risk of depositors and society as a whole. (Nier and Baumann 2003).Risk measurement and management is vital in case of banks because of its very nature. Risk reporting is the essential part of reporting of banks and have become more elaborative after different global level guidelines regarding it.

Meaning of Risk

The main business of any financial institution or banks is the acceptance of deposits and granting of loans. Thus these institutions deal with fund management. Risk and return are two important aspects of fund management. Risk and return are two important parameter of every financial decision. Risk is the probability of variation in the return. It may be related to one transaction or multiple transactions. Risk can also be called as possibility of

occurrence of financial loss. Risk in different transactions or assets may be less or more depending upon degree of chance of occurring loss.

According to Lawrence Gitman, "The term risk is used interchangeably with uncertainty to refer to the variability of returns associated with the given asset."

Accounting Standard Board) view risk as the, "Uncertainty as to the amount of benefits which includes both potential for gain and exposure to loss."

Types of Risks in Case of Banks:

Banking, by its nature deals with different types of risks. Banks need to properly measure, manage and control these risks. Risk may arise from different sources which can be external source or internal source. These sources of risk can be discussed as below:

1. **Interest Rate Risk Exposure:** The interest rate change in the market may affect the value of investment. There is always a relationship between rate of interest and value of investments. When there is increase in the rate of interest the value of investments fall and vise a versa. In case of banks interest rate risk may be defined as possibility of impact on the bank's financial position and profitability position due to changes in the rate of interest. Interest payments and interest receipts are normal part of banks' business. A normal level of interest rate risk is necessary for maintaining and improving profitability, financial position and market value. On the other hand excessive amount of interest rate risk can adversely affect banks' profitability. financial position and market value. Changes in the rate of interest will change the present value of future cash flows and affect the following :
    - Value of Operating Expenses
    - Value of Operating Income
    - Value of Assets
    - Value of Liabilities

Interest rate risk can be of the following four types. This classification of interest rate risk is given by Basel Committee in its report of management of interest rate risk in 1997:

a. Repricing Exposure: Bank is a financial institution and faces interest rate risk from various sources. Repricing is one of the source of interest rate risk. Repricing risk arises from the difference in maturity for fixed rate based assets, liabilities and off balance sheet items. It also arises from the repricing of floating rate based assets, liabilities and off balance sheet items. All these changes in interest rate may affect the profitability and value of bank and is called repricing based interest risk exposures.

b. Yield Curve Exposure: Interest rate changes may also affect the yield curve of bank. Both the slope and shape of yield curve may change due to the mismatch in the repricing of assets and investments. Unanticipated changes in the yield curve may affect bank's income and value. Repricing mismatches can also expose a bank to

changes in the slope and shape of the yield curve. Yield curve risk arises when unanticipated shifts of the yield curve have adverse effects on a bank's income or underlying economic value.

c. Basis Risk Exposure

:Basis risk is the another category of interest rate risk. This risk arises because of imperfect correlation in the interest earned and interest paid on different instruments. This difference in the interest rate may adversely affect cash flows and earning spread. As a result of this banks profitability and value will be affected.

d. Optionality Risk Exposure*:* Uses of options is the another source of interest rate risk in case of banks. Options are usually an important part of bank's assets, liabilities and off balance sheet portfolio. Options provide holder the right to buy or sell a certain assets. It is right for holder and not the obligation. Options may be :

- Exchange traded options
- Over the counter Options
- Options which are part of standard instruments

Banks use both the exchange traded options and over the counter options. Options which are part of standard instruments are also used in both the trading and non-trading activities. For example: Mostly loan provide borrowers the right of prepayment, the right to depositors to withdraw funds at any time. Adequate management of optional risk is required to avoid adverse impact on profitability and balance sheet value of banks.

2. Liquidity Risk Exposure: The banks are usually involved in investments of different assets. Liquidity risk refers to the risk which arises from the possibility of liquidation of investments at reasonable price. Liquidity of investments depend upon the market conditions of that particular investment. Liquidity risk also refers to the situation of insufficient liquid funds to meet the obligations when these become due. There may be pressure upon bank at any time due to large withdrawals and insufficiency of liquid funds to meet the obligations.

3. Market Risk Exposure: Market risk arises due to change in market prices which may affect the value of investments and assets. As a result of this balance sheet and off balance sheet position may be affected. Market prices affect banks' positions due to change in prices of debt instruments, equity instruments, foreign exchange instruments and commodity positions. In case of foreign exchange market also bank faces this risk when act as market maker in market. The value of investments and assets if greatly correlated to the changes in the market prices greater will be the market risk exposure.

4. Credit Risk Exposure : Credit risk is the other important source of risk in case of banks. Granting of loan or providing credit is the primary business activity of any bank. The lending primarily requires assessment of creditworthiness of customers. This assessment of loan may not prove accurate. Credit risk arises from the possibility that counterparty will not pay back the loan. Thus this risk mainly arises from the unwillingness or inability of borrowers to pay obligation. This risk also arises from the low grading or downfall of the counter party as a result of which the value of credit instruments fall. This risk applies to

- Loan
- Guarantees

- Acceptance
- Securities Instruments

It is very essential for banks to recognize doubtful assets timely, to create appropriate provisions against these assets for timely write off the assets. Risk management demands to keep the credit risk in limits.

5. **Foreign Exchange Risk Exposures:** Today banks' business is not limited to national boundaries rather have global appearance. Multinational banks along with having above stated exposures deal with foreign exchange risk exposures also. Banks can have foreign establishments in any of following three forms:

- **Branches**: In this case parent bank establish small business entity some other country which is called branch. Branches do not have separate legal status and totally governed by parent institution.
- **Subsidiaries**: In this case parent bank establish separate legal independent institution in some other country which is called subsidiary.
- **Joint ventures or Consortia**: Joint venture is a legally independent institution incorporated and established in a country where it runs its operations. It is established by one or more parent institution of some other country.

  Multinational Banks which are involved in foreign operations in any of the above forms face foreign exchange risk in any of the following forms:

a. **Time Horizon Risk Exposure:** There is always a time lag between settlement in one Centre existing in one time horizon and settlement in a different currency in another time horizon. Due to change in exchange rate between different time horizons bank may face time horizon risk.

b. **Sovereign Risk Exposure:** Another name of sovereign risk is country risk. This risk arises due to change in political, economic and social environment of country in which foreign establishment is existing. Unsecured foreign lending and foreign investments are also subject to sovereign risk.

6. **Off Balance Sheet Risks Exposure:** These are the risks related to certain commitments and instruments which are not part of balance sheet of bank. The use of financial instruments which are not part of balance sheet of bank lead to off balance sheet risk. These are of following four types:

a. Off balance sheet Liquidity Risk Exposure: There are certain commitments such as letter of credit, loan commitments and undrawn overdraft facilities which although not part of balance sheet leads to additional risk for banks.

b. Off balance sheet Interest rate risk Exposure: Off balance sheet items such as options, swaps and forward agreements leads to additional interest rate risk. These instrument are generally purchased as a hedge against on balance sheet interest risk exposures and lead to additional risk.

c. Off balance sheet foreign exchange risk Exposure: Foreign exchange off balance risk exposures arises from the options, swaps and future contracts related to foreign currency related transactions.

d. Off balance sheet credit risk Exposure : Off balance sheet credit risk arises from any credit commitment in which bank does not have immediate liability but such loss or liability may arise in future.

7. **Legal risk Exposure:** The source of the legal risk is the inadequate or incorrect legal advice or incorrect legal documentation. There may be some court case which may have future liability implication for a single bank or group of banks. The legal implication of some laws may be accruing certain liability upon bank if the right of counterparty is affected.

8. **Reputational risk Exposure:** Reputational risk arises from the loss of reputation or goodwill of bank due to some event or news. There may be adverse impact on the welfare of customers or other stakeholders due to some action of banks. The confidence of the stakeholders is shaken which lead to fall in profitability and balance sheet value.

9. **Event Risk Exposure:** There may be some unexpected internal or external event which has adverse impact on the value of bank. This is called event risk. Depending upon the complexity of event it may effect bank value for short time period or long time period.

10. **Purchasing Power Risk Exposure:** The excessive rate of inflation and deflation may adversely affect the value of investments and assets which is called the purchasing power risk or inflation risk.

11. **Tax Risk Exposure:** Taxes are related to external business environment risk. The rate of taxes may increase which may adversely affect the bank's profitability and balance sheet value which is called the Tax Risk Exposures.

So a bank is subject to different types of risk exposures. These risk exposures arises from different types of sources which may be internal environment risk source or external environment risk source.

Concept of Risk Reporting

Risk related disclosures or reporting means adequate public disclosures related to risk exposure of bank from different sources as elaborated in the concept of risk above. The following diagram shows the different aspects of risk reporting:

According to Beretta and Bozzolan (2004), "Risk disclosure can as a consequence of this definition can be defined as communication of facts that have the potential to affect expected results."

Parameters of Risk Reporting: Risk reporting like any other disclosures has qualitative and quantitative aspect of Reporting. It can be elaborated as follows:

Qualitative Parameters of Risk Reporting: Basle Committee has identified certain qualitative characteristics of information. These are the same as the qualitative characteristics of disclosures as identified in accounting literature. The Report of Basle Committee titled "Enhancing Bank Transparency "issued in September 1998 defines transparency of information

, *" as public disclosures of reliable and timely information that enables users of that information to make accurate assessment of banks financial condition and performance its business activities ,and risks related to those activities"*

The Enhanced Disclosure Task Force (2012) sets out seven principles for risk disclosures which basically relates to quality of Risk Reporting:

1. Understandable Risk Disclosures

2. Comprehensive Risk Disclosures

3. Relevant Risk Disclosures

4. Management of Risk Disclosures

5. Consistent Risk Disclosures

6. Comparable Risk Disclosures

7. Timely Risk Disclosures

P. Wallage (2000) has also listed certain parameters of qualitative aspect of Risk Disclosures which are

- Relevant
- Reliable
- Neutral
- Understandable
- Comparable.

Thus the Qualitative characteristics of risk disclosures can be described as below:

1. Comprehensiveness: This characteristic requires that risk disclosures should be comprehensive. It means there should be coverage of each and every aspect of risk. There should be measurement, aggregation and consolidation of risk information of different entities and sub entities.

2. Relevance: Second characteristics of qualitative risk disclosures require that information must be relevant for decision makers. Information will be said to be relevant if it helps to access the expected risk and return of investment and lending. For government and other regulatory bodies information will be relevant when it helps to evaluate the safety and soundness of banks.

3. Timeliness: Timeliness requires that risk information should reach the stakeholders on time before that information loses relevance for decision making. It should be provided at regular intervals and more frequently. Information communicated delayed is the same as non-disclosure of information.

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4. Reliability: Risk information must be reliable. It means it sincerely represent the facts which it supposed to represent. It must be

- Verifiable in nature
- neutral
- Free from material errors
- Free from biasness
- Prudent
- Complete in all respects.

5. Comparability: Risk disclosures must be comparable across institutions and over time. Stakeholders need to compare information for the purpose of taking various decisions. Comparability of information requires the following parameters:

- consistent accounting policies and procedures should be adopted from
- uniform and standardized measurement concepts should be used
- Changes in concepts, policies and procedures if any should be disclosed with reasons

6. Materiality: Risk information disclosed must be material for the stakeholders for the purpose of decision making**.** Omission of such information can affect the decision of stakeholders.

7.Undestandability: Information should be easy to understand by different stakeholders. Most of the stakeholders and decision makers do not have knowledge of technical concepts and methods. Therefore technical terms used in disclosures must be properly defined and explained. Technical methods should be elaborated in detail. Tables ang graphs must support the text for proper presentation and understanding.

Quantitative characteristics of risk disclosures can be described as below: Qualitative characteristics of risk reporting discussed above ensures the quality of risk reporting for the purpose of decision making. This is basically related to description of management strategies and policies with regard to risk reporting. Quantitative characteristics of risk reporting disclose the quantum, value or magnitude of risk level and its impact in numerical terms on the profitability and financial position of the firm. Quantitative characteristics of risk reporting can be described as below:

1. Amount or quantum of Risk: There should be proper disclosure with regard to quantum or value of each category of Risk. For example:

- Amount of loan ,investment ,trading and off balance sheet exposures
- Amount of problem loan and other assets
- Amount of interest rate sensitive assets and liabilities
- Amount of off balance sheet interest rate exposures
- Amount of Hedged exposures

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- Amount of Un hedged exposures
- Amount of Foreign exchange translation effect
- Amount of liquid assets

2. Concentration or Aggregation of Risk: Quantity of risk reporting also requires that risk amount also be disclosed on aggregation or concentration of risk form. This aspect is drawn from the comprehensive characteristics of risk reporting. It includes as follows:

- Aggregate amount of exposures belonging to banks and other commercial institutions
- Amount of exposures belonging to government entities
- Amount of domestic and international exposure
- Amount of secured and unsecured exposures
- Amount of major or concentration of credit exposure
- Amount of exposure from derivatives
- Amount of problem loan
- Breakdown of fixed and floating rate items.
- Concentration of foreign exchange exposure by currency
- Concentration of deposits and other fund providers. Etc.

3. Amount of Allowances: Quantification of Risk also includes information about allowances which particularly include following information:

- Amount of allowances for meeting different kinds of losses
- Change in amount of allowances from one time period to another

4. Control of Risk /Limits Disclosures: Other aspect of quantitative risk reporting relates to disclosures related to controlling aspects of risk. It includes following:

- Use of credit limit
- Internal Credit Rating
- Amount of collateral and guarantees'
- Use of credit scoring
- Total amount of exposures on daily, weekly and monthly time period

Conclusion: Financial system is the backbone of any economy and banks are primary participant of financial system. Banks today not only drives economic growth but also leads towards social transformation. Public disclosures play an important role for any entity having various categories of stakeholders. More disclosures are helpful in reducing information gap between the group who is having abundance of assess on the information and the other who can assess little information. The main business of any financial institution or banks is the

acceptance of deposits and granting of loans. Thus these institutions deal with fund management. Risk and return are two important aspects of fund management. Risk and return are two important parameter of every financial decision. Risk is the probability of variation in the return. It may be related to one transaction or multiple transactions. Risk can also be called as possibility of occurrence of financial loss. Banking, by its nature deals with different types of risks. Banks need to properly measure, manage and control these risks. Risk may arise from different sources which can be external source or internal source. Risk related disclosures or reporting means adequate public disclosures related to risk exposure of bank from different sources as elaborated in the concept of risk. Basle Committee has identified certain qualitative characteristics of information. These are the same as the qualitative characteristics of disclosures as identified in accounting literature. Qualitative characteristics of risk disclosures are such as Understandability of Risk Disclosures, Comprehensive Risk Disclosures, Relevant Risk Disclosures, Consistent Risk Disclosures, Comparable Risk Disclosures and Timely Risk Disclosures. The quantitative aspect of risk disclosures requires to disclose amount of each category of risk, maximum amount of exposure and allowances related to exposures. Thus from the above discussion it is clear that bank in order to provide complete picture of risk both quantitative and qualitative disclosures should provide. There should be perfect and healthy balance between quantitative and qualitative disclosure practices.

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