Enhancing Risk Management of Commercial Banks for a Sustainable Development

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1. Risks and risk management in operations of commercial banks

In the market economy in Vietnam, operations of commercial banks imply many potential risks, and they have developed along with development of banking services and products.

Commercial banks are financial intermediaries whose main and regular operations include mobilization of deposits, supply of credits and other services, investment in joint ventures, and trade in securities, etc. So their businesses are affected by various factors, such as socioeconomic environment, macroeconomic and microeconomic policies of the government and central bank. Moreover, globalization and international integration increases degrees of risks to banking operations and once the risks happen their consequences are very serious. Therefore, improving ability and efficiency of the risk management of commercial banks for a more sustainable development is a task of great urgency.

Risk management is a scientific, overall and systematic approach that aims at identifying, controlling, preventing and reducing losses and unfavorable impacts of risks. This process comprises: risk identification, risk analysis, risk assessment, risk control and prevention, and risk financing.

- Identification of risk: It is a process of continuously and systematically determining banks' operations. It includes tasks of keeping watch, examining, and studying the context and all operations of the bank aiming at listing all risks, both ones that have taken place in the past and potential ones, thereby working out appropriate measures to control and finance them.

To identify the risks, managers should make a list of all possible risks that the bank may face by working out questionnaires about possible risks and investigating them, analyzing financial statements, inspecting the context, analyzing business contracts, and cooperating with governmental bodies and related authorities.

- Analysis of risk: This task aims at identifying causes of the risk. This is no easy task because a risk may have various causes. The analysis of risk can help with working out of effective measures to prevent the risk. By identifying causes of risk, one can take measures to change them, thereby preventing the risk.

- Assessment of risk: This task requires data gathering and analyzing and formation of a matrix based on gathered data and used for assessing the risk.

To assess importance of risks to the bank, two factors could be used: frequency of risks (rate of occurrence) and impact of the event (severity of the consequences), the latter is a decisive one.

- Risk control and prevention: The risk control is central to the management of an enterprise. The risk control means the use of measure, techniques, instruments, strategies, and action plans to prevent, avoid or reduce losses and unwanted impacts on the bank. Some useful ones are measures avoid the risk, prevent the loss, reduce the losses, transfer the risk, diversify the risk, and management of information, etc.

- Risk financing: Once risks have happened the bank management should keep a close watch on the situation, assess exactly losses of assets, human resource and legal costs, and then adopt appropriate risk financing measures. These measures may be divided into two groups: risk retention and risk transfer.

2. Main risks to commercial banks

In fact, risks can happen in all banking operations: making payments, supplying credits, receiving deposits, trading in foreign exchange, or making investments. That is why banks in developing countries always pay full attention to studies and analyses of the banking risks even in periods of economic stability. The banking risks are numerous and diverse but the most common ones are credit risk, exchange risk, liquidity risk, market risk, interest rate risk and operational risk.

- Credit risk: This risk takes place when credits are supplied and it is a chance that a borrower or trade debtor can't repay debts, or repay timely, as promised.

So we can say that the credit risk happens in relations in which the bank is creditor and debtors don't, or can't, repay obligations when due. It takes place when banks supply loans, discount negotiable and transferable instruments, provide financial leasing and guarantee services, and act as underwriters. This is also called default risk – a kind of risk relating to quality of credit service.

- Liquidity risk: It is the possibility that the bank can make payments when due because it fail to turn its assets into cash timely or borrow money from a third party to settle its contracts. In other words, this risk happens when the bank is temporarily insolvent or a bank run takes place.

- Exchange risk: This risk implies a chance of loss when the exchange rate changes unfavorably to the bank trading or lending in foreign exchange. This risk appears when the exchange rate fluctuates or inexact estimates of economic factors lead to losses to the bank.

- Market risk: It is the risk that the value of investments or assets falls due to changes in market factors, such as interest rate, exchange rate, stock prices or commodity prices, etc.

- Interest rate risk: This risk appears when changes in the interest rate and other factors relating to the interest rate lead to losses of assets or reduction in income of the bank. The interest rate risk may have various forms caused by changes in the base rate, the yield curve, relation between different interest rates, and accompanied options.

- Operational risk: This risk comes from shortcomings in the bank's function and management, such as corruption, poor managerial skills, and lack of plans to reduce losses caused by risks, etc.

Reality in developing countries shows that all above-mentioned risks can be identified and assessed, and the banks can work out plans to prevent risks and reduce losses. To achieve this aim, commercial banks should develop a system of effective policies to control risks and realize that risk management is a continuous process that should be implemented at all levels of an organization, and a must to financial institutions in their effort to achieve their goals, and ensure their survival and financial transparency as suggested by the Basel Committee.

The above-mentioned risks may appear anytime and cause great losses to the bank's assets and public image, but the credit and liquidity risks are of high degrees of frequency and danger.

3. Risk management in Vietnamese commercial banks

Looking back on the banking system in the past few years, we can see that risks to the banks are alarming when bad debts, law cases relating to the banks and potential risks tended to increase. This means that the risk management in commercial banks was not effective, especially regarding the credit and liquidity risks.

a. Credit risk: According to data gathered by the

SBV, the supply of credit at present is still the main activity of the banks and accounts for 70% to 90% of assets of the banking system. It's worth noting that a large quantity of loans have been supplied to investors in stock and realty markets. As the governing body of the system, the SBV has kept a close watch on the supply of loans to investors in the stock market, inspected the supply of credit to real estate agents (Directive 03/2008/ CT-NHNN), limited the loan to investors in the stock market to 3% of the total loan and 20% of the legal capital (Decision 03/NHNN) but it was too late because many commercial banks have gone beyond this limit. To deal with this mistake, many banks have made another: they increased the supply of loan to real estate agents and customers to reduce the loan for securities investors to the 3% limit.

In addition, the economic climate was not favorable to commercial banks: when the supply of credit increased, the inflation broke out and made many corporate borrowers become default. And as a result, the proportion of bad debts stayed at a high level in spite of efforts by the banks.

b. Liquidity risk: Fall in the total deposit has happened in HCMC. Up to April 16, 2008, the total deposit held by commercial banks was VNĐ,225 billion lower than the one reported at the end of March 2008, in which the deposit in savings accounts fell by 1.74% in state-owned commercial banks and 0.28% in joint stock commercial banks; and the deposit from companies with the two groups of banks felt even deeper, according the HCMC branch of the SBV.

According to Credit Information Center, many banks, because of their small legal capital, have turned short-term deposits into long-term investments in risky fields such as realty and stock markets. CIC also reported that some banks had put some 60% of their bank deposit in real estate while 80% of the deposits were of short term. Moreover, these banks held only small quantities of negotiable instruments of high liquidity (T-bills or SBV-bills) so they can hardly improve their solvency.

Regarding their investment portfolios, proportion of securities was too big and risky: VNĐ,636 billion in the Á Châu Bank; 6,842 billion in Kỹ Thương Bank; 3,968 billion in Đông Nam Á Bank; 3,600 billion in An Bình Bank; 2,169 billion in Hàng Hải Bank; and 1,678 billion in Ngoài Quốc Doanh Bank (data gathered by vneconomy at the end of 2007) while prices of most shares on the stock exchange and OTC market have fallen by 50% or above, and these banks are facing great losses.

Commercial banks have once met with difficulties when the required reserve ratio increased frequently (and stays around 11% now), and their reserves were not big enough to buy VND20,300 billion worth of compulsory SBV-bills, and then they faced a prospective shortage of liquidity in June 2008 when the Treasury has to transfer VND52,000 billion it deposited with state-owned commercial banks to the SBV. All these events cause harm for sources of finance of commercial banks.

From the said credit and liquidity risks in commercial banks, we can draw conclusion about shortcomings in their risk management:

- Each commercial bank only pursues its own objectives (increases in credit and services supplied, and in customer base, etc.) but fails to cooperate with others in building a system for risk management or information exchange. Criteria for keeping books, auditing, and risk assessing and control suggested by the Basel Committee have not applied properly by commercial banks.

- Army of experts of commercial banks is very small although they have tried to provide their personnel with training courses with a view to modernizing their operations. In fact, many bank employees failed to fulfill their tasks and suggest necessary warnings and measures to prevent risks in credit supplying decisions.

- Financial strength of Vietnamese commercial banks is poor. They lack managerial skills and professional manner. Management process doesn't get full attention.

- The CIC under the SBV and similar departments in commercial banks limit themselves to tasks of gathering and supplying information and statistics. They failed to give warnings of risks and suggest measures to prevent or limit risks and resulting losses in banking services.

- The SBV failed to fulfill its functions as the governing body of the banking system, such as drafting and issuing guidelines and regulations about risk management according to international practices, and applying standards of risk control set forth by the Basel Committee as done by commercial banks all over the world. Moreover, the SBV has suffered direct influence from the Government and interventions from other governmental agencies when it carries out the task of controlling and supervising operation of commercial banks. Interventions from governmental agencies in the banking activities are so far-reaching that interests and autonomy of commercial banks are violated and not protected by law, especially in cases of disputes.

4. Measures to enhance the risk management for a sustainable development

In our approach to the risk management, we want to suggest here some measures to improve the situation.

a. Overall solutions:

- Firstly, the SBV should cooperate with ministries to build the accounting system according to the international accounting standard (IAS), and work out policy solutions to perfect internal auditing and controlling methods for commercial banks with a view to reaching international standards.

- Secondly, the banking inspection machinery from central to local levels must be improved. Relative independence and autonomy in operation and management must be given to the SBV machinery. Basic principles of banking supervision set forth by the Basel Committee must be applied. Precautionary rules for inspection task must be observed.

- Thirdly, a system and measures to control flows of foreign capital and debts must be built, especially a mechanism for supervising loans in foreign exchange supplied and borrowed by commercial banks, in order to avoid the exchange risk and give early warnings to the banks.

- Fourthly, The SBV must support the risk management by commercial banks by supplying experience of risk management from foreign banks, issue guidelines on this task and apply sanctions to banks violating banking regulations on this task, and provide bank employees with training courses in the risk management.

- Fifthly, criteria for granting business license and technical certificates to commercial banks based on their financial strength and safety indicators must be enhanced.

- Finally, the banking system must be reformed. Certain state-owned banks could be privatized and their shares could be listed on the stock exchange in order to distributed risks and change the structure of banking products.

b. Specific solutions:

- Firstly, commercial banks must be aware, and share knowledge, of necessity and importance of the building of risk controlling systems, and get ready to share necessary information, and employ the same instruments of identifying and assessing risks as commercial banks in developing countries.

- Secondly, it's necessary to accelerate modernization of the banking system by providing it with IT facilities for analyzing, assessing and measuring risks, including the credit risk. The supply of information about customers and risk managing system in the banking sector must be upgraded to get better performance and become a source of identical and true information available for all banks.

- Thirdly, commercial banks had better cooperate with related organizations to supply short-term training courses in risk identification, analyses and assessment to bank employees. According to many experts in this field, no analyzing method can replace experience and professional assessment regarding the risk management. To control the risks effectively, therefore, commercial banks should equip themselves with armies of employees with experience and knowledge of the risk management.

- Fourthly, expertise of bank employees must be improved and the public image of the bank should be built with a view to reducing ethical and operational risks. Transparency of information must be enhanced by sending regular reports or financial statements to major partners and customers of the banks and auditing and inspecting bodies ■

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