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ILLUSTRATIONS: ROHNIT PHORE

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Banking on uncertainty

Banks need to recalibrate their risk appetite to cope with Covid-19. An effective and well-tested funding plan will help the bank to tide over the unforeseen shortfalls.

COMMERCIAL BANKS HAVE a central role to play in supporting the economy during the current pandemic and in facilitating recovery afterwards. Given the increase in NPAs during the pandemic, banks need to recalibrate their risk appetite and conduct various scenario assessment to estimate sufficient provision and capital requirements to sustain lending. The risk appetite statement of a bank entails an assessment of the current and desired risk profile that precisely tells the level of risk the bank is willing to take and an action plan to achieve it. A key lesson of the recent NPA crisis in the Indian banking system (aggravated by Covid-19) is that banks' senior executives need to transmit their risk appetite to risk-takers and managers.

A bank needs to articulate risk appetite in quantitative terms. Normally, the risk appetite statement has been quantified in terms of the target CRAR (or CET1 & Tier 1), target credit rating, portfolio credit risk position (eg average corporate probability of default), target return on equity, etc. A more risk-sensitive indicator would reflect the utilisation of economic capital with respect to available capital.

For a more granular, bottom-up approach, banks will have to perform business and risk profile analysis in each risk segment (credit risk, market risk, liquidity risk and other risks) and derive the risk tolerance level.

A bank can set credit risk appetite through economic capital-based scenario analysis to express risk appetite in a more comprehensible manner. It addresses the unexpected risk of the business, which is a true measure of uncertainty. Many supervisors globally prefer the economic capital-based analysis of risk appetite. A more objective quantitative manifestation of risk appetite will guide the bank to take day-to-day credit decisions at the line level, help the bank to read macroeconomic scenario-based stress testing results and conduct capital planning.

A proper selection of risk plan requires decisions about industry sectors and geographic regions that can provide growth at credit losses within the bank's risk tolerance level. For example, if average risk tolerance is less than 1% on assets, then the bank needs to target a probability of default (PD) of less than 2%, assuming loss given default (LGD) of 50% for the pool. Similarly, the unexpected risk limits can be set based on Limit=EC×(1/LGD) and accordingly, assets may be chosen.

Market risk appetite reflects the nature of traded assets the bank holds at present and wishes to invest in future. The bank has to examine whether it has or can raise enough capital to absorb losses under normal and (mild, moderate or severe) stress conditions, on such portfolios. If there is a constraint on additional capital allocation to mitigate these losses, the bank needs to limit the sensitivity of its trading book in terms of duration, beta and/or VaR limits. It also needs to set return on investment targets and assess the trade-off between risk limits and returns. Such a market risk appetite statement would be able to link business growth, capital planning, and portfolio composition and return optimisation.

A Liquidity Risk Appetite Statement should move beyond regulatory compliance with liquidity coverage ratio (LCR) and net stable fund ratio (NSFR) guidelines to better manage the uncertain time. It should project liquidity requirements under normal and stressed episodes and examine the ability of the bank to raise the requisite amount of liquidity. It would also enable the bank to develop contingency funding plans (CFPs) that identify a set of early warning signals and associated liquidity risk management strategies, to guard against bank-specific and systemic crisis episodes. Such effective and well-tested funding plan will help the bank to tide over the unforeseen shortfalls.

The accompanying graphic shows how risk appetite metric can be used for overall risk management and business strategy setting. The central office can create the metric and can make zonal and regional offices accountable to manage the banking risks.

The indicators of risk appetite, trigger level, FY 21 positions, ownership & action points and basis of setting the indicators are summarised in the table.

Risk appetite metric for bank's overall risk management

Category	Indicator	Appetite	Trigger level	Position FY 20-21	Owner & Action Points	Basis
Credit risk	Exposure to Top 20 real estate exposure	12% 15%	10% 12%	8% 10%	Credit department at RMD; ZOs, ROs are accountable	ECL & EC Based RAROC based
Asset	NNPA	<3%	2%	5%	RMD; credit units & NPA	RC, EC analysis
quality	Slippage RW density	<5% 75%	3.5% 70%	8% 80%	Dept. accountable =>Reduce exposure to certain sectors	& future growth
Capital	CET1 ratio CRAR	>9% >13.5%	8% 12%	7.5% 12%	Board & RMD	Capital & business plan
Financial	ROA	>1%	0.50%	0.40%	Board & management committee	Capital & business plan
External rating	Tier 1 bonds	AA+	AA-	AA	Board	Target risk profile

Source: Author's own illustration; Note: RMD: Risk Management Department; ECL: Expected Credit Loss; NPA: Non Performing Assets; ZOs: Zonal offices; ROs: Regional Offices; CET1: Common Equity Tier 1 capital; RW density: Credit Risk weighted assets to gross advances; NNPA: Net non-performing assets; CRAR: Capital to Risk Weighted Assets Ratio; ROA: Return on Asset.

Business plan and associated risk appetite should be properly united and need to be dynamically reviewed by senior management of banks. Every parameter in the risk appetite framework requires to be aligned to expected earnings and its relative contribution to the risk. The objective of risk appetite framework is not to restrict any growth of balance sheet but to meet organisational strategic goals or to meet interrelated objectives keeping in mind the risk tolerance positions. It clearly lays out the protocol to be followed if the risk appetite limits are breached; thereby safeguarding the balance sheet of banks and sustaining business in the long-run.