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RISK MANAGEMENT OF CO-OPERATIVE BANK THROUGH BASEL

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Abstract—*Risk management is a major aspect in every organization as there is frequent changes in macro level and in the present day contest we are dealing with lots of investment avenues among them investment in banking sector is highly admirable by the investors. The risk management of co-operative bank is more crucial than commercial bank as the co-operative bank which comes under State Co-Operative Society Act. As it is an independent body and several act of co-operative society levied on the bank laws. The Basel committee is initiated only for the regulation of banks through on the present day concern risk is a major factor for any type of investment and managing that risk is another prudent decision. As pre RBI guideline.. Mostly the BASEL-2 comprises of three aspects. so from this three aspects MARKET DECIPLINE is very sensitive aspect where the investment of the banks are only made through Capital Market, Bond Market and last but not least Money Market. These Market instruments are much essential to hedge risk. Though risk free instruments like Govt. Bond, Treasury bill, and Gold are there but for an efficient return portfolio return is directly proportional to risk. So it is the only reason why people relied upon it and make their investment in this bank. The high the CAR higher the reliability of the bank. So absence of market aspect CAR plays an important role in mitigating the risk for which more investment takes place by the customer than other bank and it is again create an easier task for the banker to run the business in a smoothen way and at the same time aim of the concern is to increase the spread. The third concept of Basel-2 i.e. Supervisory Review is fully based on the supervision of RBI to the banking sector whether they are correctly maintaining the norms along with the provisions and acts. So it is an important issue and noticeable fact and this lacuna can only be fulfilled by providing proper investment knowledge to the bankers along with applicability in a real time area, by which it can be fulfilled the basic criteria of Basel-2 in the rural, semi urban and urban area where the idea about market investment is very low.*

Basel I: the Basel Capital Accord

Capital adequacy soon became the main focus of the Committee's activities. In the early 1980s, the onset of the Latin American debt crisis heightened the Committee's concerns that the capital ratios of the main international banks were deteriorating at a time of growing international risks. Backed by the G10 Governors, the Committee members resolved to halt the erosion of capital standards in their banking systems and to work towards greater convergence in the measurement of capital adequacy. This resulted in a broad consensus on a weighted approach to the measurement of risk, both on and off banks' balance sheets.

The main focus of Basel-1 is CAPITAL ADEQUACY and the measurement of capital adequacy is done only through CAR (Capital Adequacy Ratio).

1. CAPITAL ADEQUACY RATIO

Capital Adequacy Ratio (**CAR**), also known as **Capital to Risk (Weighted) Assets Ratio** (**CRAR**), is the ratio of a bank's capital to its risk. National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and complies with statutory Capital requirements.

It is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures.

Capital adequacy ratios (CARs) are a measure of the amount of a bank's core capital expressed as a percentage of its risk-weighted asset.

Capital adequacy ratio is defined as:

$$\text{CAR} = \frac{\text{Tier 1 capital} + \text{Tier 2 capital}}{\text{Risk weighted assets}}$$

TIER 1 CAPITAL = (paid up capital + statutory reserves + disclosed free reserves) - (equity investments in subsidiary + intangible assets + current & b/f losses)

TIER 2 CAPITAL = A(Undisclosed Reserves + B) General Loss reserves + C) hybrid debt capital instruments and subordinated debts

Where Risk can either be weighted assets (a) or the respective national regulator's minimum total capital requirement. If using risk weighted assets,

$$\text{CAR} = \frac{T_1 + T_2}{a} \geq 10\%.$$

Basel II: the New Capital Framework

In June 1999, the Committee issued a proposal for a new capital adequacy framework to replace the 1988 Accord. This led to the release of the *Revised Capital Framework* in June 2004. Generally known as “Basel II”, the revised

Following the June 2004 release, which focused primarily on the banking book, the Committee turned its attention to the trading book. In close cooperation with the International Organization of Securities Commissions (IOSCO), the international body of securities regulators, the Committee published in July 2005 a consensus document governing the treatment of banks’ trading books under the new framework. For ease of reference, this new text was integrated with the June 2004 text in a comprehensive document released in June 2006.

Objective

The final version aims at:

1. Ensuring that capital allocation is more risk sensitive;
2. Enhance disclosure requirements which would allow market participants to assess the capital adequacy of an institution;
3. Attempting to align economic and regulatory capital more closely to reduce the scope for arbitrage while. the final accord has at large addressed the regulatory arbitrage issue, there are still areas where regulatory capital requirements will diverge from the economic capital.

Basel – II norms are based on 3 pillars:

- Minimum Capital – Banks must hold capital against 8% of their assets, after adjusting their assets for risk
- Supervisory Review – It is the process whereby national regulators ensure their home country banks are following the rules.
- Market Discipline – It is based on enhanced disclosure of risk

2. MINIMUM CAPITAL REQUIRMENT

Academics, practitioners, and regulators all recognise and agree that capital is required for banks to operate smoothly because capital provides protection. The critical question is how much, and what type of, capital a bank needs to hold so that it has adequate protection.

In the simplest form, capital represents the portion of the bank’s liabilities which does not have to be repaid and therefore is available as a buffer in case the value of the bank's assets decline. If banks always made profits, there would be no need for capital. Unfortunately, such an ideal world does not exist, so capital is necessary to act as a cushion when banks are impacted by large losses. In the event that the bank’s asset value is lower than its total liabilities, the bank becomes insolvent and equity holders are likely to choose to default on the bank’s obligations.

Regulatory View

Regulatory capital is the minimum capital requirement as demanded by the regulators; it is the amount a bank must hold in order to operate. A regulator’s primary concern is that there is sufficient capital to buffer a bank against large losses so that deposits are not at risk, with the possibility of further disruption in the financial system being minimized. Regulatory capital could be seen as the minimum capital requirement in a “liquidation / runoff” view, whereby, if a bank has to be liquidated, whether all liabilities can be paid off.

Supervisory Review

This is a regulatory response to the first pillar, giving regulators better 'tools' over those previously available. It also provides a framework for dealing with systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. Banks can review their risk management system.

It is the Internal Capital Adequacy Assessment Process (ICAAP) that is the result of Pillar II of Basel II accords.

3. MARKET DECIPLINE

The onus on the banks, financial institutions and sovereigns to conduct business while considering the risks to their stakeholders. Market discipline is a market-based promotion of the transparency and disclosure of the risks associated with a business or entity. It works in concert with regulatory systems to increase the safety and soundness of the market.The risks associated with partial ownership in a company can decrease the likelihood of involvement in the market. Market discipline increases the information available to the public by encouraging the release of timely information detailing a company's assets, liabilities and general financial information. This reduces the uncertainty and promotes the function of the market as an exchange between lenders and borrowers.

For example, the capital requirements for a bank might be to keep 1% in reserves. Market discipline, on the other hand, encourages banks to keep a higher amount to reduce their liquidity risks and increase the confidence of their depositors.

About Co-Op Society

The Co-operation Department was created with the objective of strengthening the co-operative movement in the State. Initially, the Co-operation Department remained part of one of the development Department. The Department of Cooperation and its field formations have been organized with the main objective of strengthening the Cooperative Movement in our Country and to ensure better income generation of the members constituting Cooperative Societies, using their common wealth through group efforts.

About the Bank: The Kendrapara Urban Co-operative Bank Ltd., one of the largest Co-operative Bank in the state in its outlook and approach has the objective of progress & prosperity of all. From a humble beginning in September, 1986 with a share capital of Rs1.75 lakhs held by 523 members and being registered under Co-operative Societies Act vide Registration No123KE/26.09.1986. The Bank has launched different loan schemes tailor-made to suit the needs of various types of customers. The procedure for sanctioning of loans under various schemes has been simplified and relaxed with a view to attract new customers and facilitating speedy sanction of loans. The bank is providing investment opportunities to all sections of the people in the form of attractive deposit schemes and attractive interest rates.

Bank's tier one capital consists of;

1. Paid –up capital

Less Intangible asset and losses, that resulting net paid-up capital.

2. And in other case the reserve and surplus are taken care off. And hence they consists (statutory reserve, capital reserve etc.

So the tier-1 consists of (1+2)

Bank's tier two capitals consist of;

Undisclosed reserve, revaluation reserves, general provision and loss assets, investment fluctuation reserves etc.

A: adjusted value of funded risk assets

B: adjusted value of off-balance sheet items

Total capital: (A+B)

Risk weighted assets and exposures;

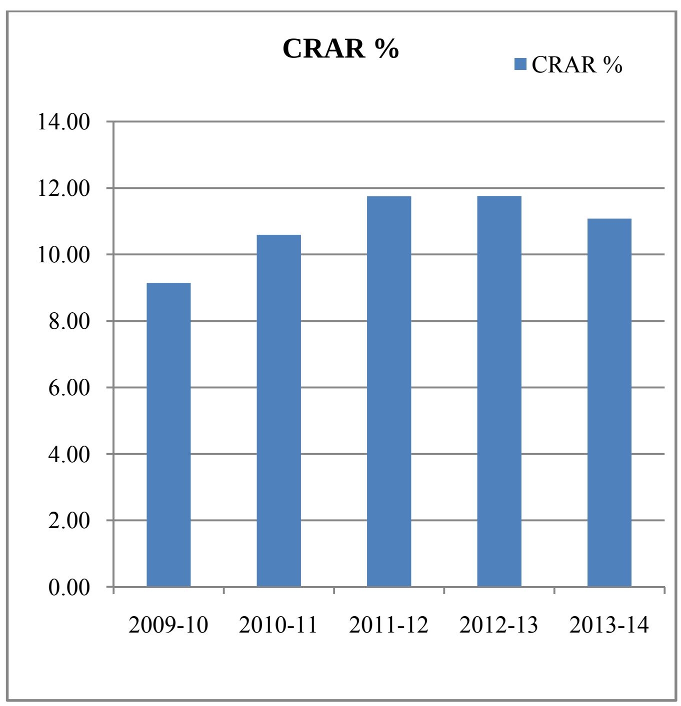
1. All the balances except cash are taken weights as 20% and cash 0%.
   It includes balances in current accounts and in other banks.
2. Investment like guaranteed by central govt. security, and state govt. securities are taken weights as 2.5%. and investment where payment of interest are not guaranteed by state or central govt. are taken as 122%,hece claims on other commercial banks, other urban co-operative bank and other investment are taken weights as 20%. And investment in bonds issued by public financial institution is 102.5%.
3. Loans guaranteed by central and state govt. are taken as 0% and lease assets, loans guaranteed by PSU's, loans not guaranteed by state or central govt. are taken as 100%. The loans which will be given on the mortgage of individual housing property, silver are considered as 50%.
4. Money at call and short notice are taken weights as 20%.
5. Premises, furniture and fixture, computer, veichil are considered as 100%.
6. Interest due on govt. securities, accrued interest on CRR is taken as 0% and interest received on staff loan and banks are of 20%.
7. Market risk on foreign exchange and gold are considered as 100%.

CRAR REPORT OF KUCB (2009-2014) (in lakh)

SL. NO	PARTICULARS	2009-10	2010-11	2011-12	2012-13	2013-14
A.	TIER-1 CAPITAL	298.85	370.33	463.64	515.21	554.43
B.	TIER-2 CAPITAL	33.12	67.64	67.1	84.93	104.08
	A+B	331.97	437.97	530.74	600.14	658.51
C.	TOTAL RISK WEIGHTED ASSETS	3629	4134.63	4515.53	5101.8	5943.7
	CRAR (A+B/C) %	9.15	10.59	11.75	11.76	11.08

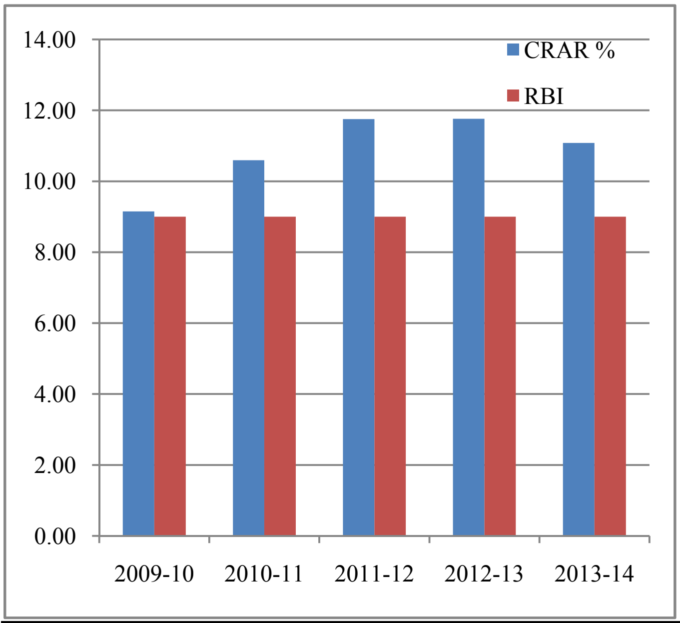
- ✓ **From the above table, we can easily see the TIER-1 capital, TIER-2 capital of the bank as per their audit report have measured in successive year.**
- ✓ **The calculated risk weighted asset as per the weights maintained by the bank had grown up from 3629 to 5943.7**
- ✓ **CAR, it is done by dividing the net capital (tier-1 and tier-2) to the total risk weighted assets.**

CHART SHOWING CRAR OF KUCB (2009-2014)



By the above chart, we can easily see the trend of Capital Adequacy Ratio to the corresponding year i.e. 2009 to 2014.

CRAR RBI VS KUCB



- ✓ **The above chart shows the comparative analysis of Capital Adequacy Ratio of KUCB and the provision and guideline mentioned by RBI.**
- ✓ **The blue BAR is showing the CAR percentage of KUCB and the red BAR is about RBI.**
- ✓ **The period I have taken is from 2009 to 2014.**

4. CONCLUSION

- On the present day concern risk is a major factor for any type of investment and managing that risk is another prudent decision.
- When co-operative bank is concerned, the bank diversifies its risk through various avenues. (Explain in risk exposure), as pre RBI guideline.
- The normal talk between people about co-operative bank that investing in co-op bank is quite risky. but my study shows a result that co-op banks are good in terms of risk management as their regulation undertaken by RBI protocols.
- So there is no much difference by managing risk in co-op banks and commercial banks.
- Mostly the BASEL-2 comprises of three aspects. so from this three aspects MARKET DECIPLINE is very sensitive aspect where the investment of the banks are only made through Capital Market, Bond Market and last but not least Money Market.
- These Market instruments are much essential to hedge risk. If banks hold 100% investment through lending activities, sometimes due to Non Performing Asset the investment will go into vain.
- But if the bank invest 60% portion in the market instrument, if 40% will go down, the loss will mitigate through this 60% portion.
- Though risk free instruments like Govt. Bond, Treasury bill, and Gold are there but for an efficient return portfolio return is directly proportional to risk.
- As these are risk free instrument its return are low as to return from market.
- Urban co-operative bank in a semi urban area somehow the bank failed to have its market expose so that the basic functions are only be maintained i.e. borrowing and lending.
- Though it provides higher interest than public sector bank, it's only because it have huge branch in the locality and turnover is relatively high than other banks.
- As it have fulfilled the BASEL-1 norm which is drastically said about CAR i.e. Capital Adequacy Ratio and hence its CAR is relatively high than other public sector banks in the locality.
- So it is the only reason why people relied upon it and make their investment in this bank.
- The high the CAR higher the reliability of the bank.
- So absence of market aspect CAR plays an important role in mitigating the risk for which more investment takes place by the customer than other bank and it is again create an easier task for the banker to run the business in a smoothen way and at the same time aim of the concern is to increase the spread.
- The third concept of Basel-2 i.e. Supervisory Review is fully based on the supervision of RBI to the banking sector whether they are correctly maintaining the norms along with the provisions and acts.
- So it is an important issue and noticeable fact and this lacuna can only be fulfilled by providing proper investment knowledge to the bankers along with applicability in a real time area, by which it can be fulfilled the basic criteria of Basel-2 in the rural, semi urban and urban area where the idea about market investment is very low.