Risk Management in the banking and insurance sector

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Abstract

Risk management is becoming an integral part of every organization, especially for the banking and Insurance sector because of their high-risk business. Both sectors try to manage the risks of their clients and their own risks. But, challenges in the banking and insurance industry are frequently influenced by the liquidity rations and the amount and quality of capital as ground requirements for risk management. The risk exposure in recent times is becoming more complex, more dynamic and diverse. Hence, we need to understand the risks which can be taken and the risks which should be avoided. In the other side insurance policies are long term, enabling insurers to stabilize the financial system and often insurance is the final transfer of risk. In this paper we will analyze an overview of risk management in the banking and insurance sector.

Keywords: Risk management, banking sector, insurance sector, Basel II, III, BRRD, SRM.

Introduction

The risk management requires an integration of management into the companies system, process and culture. The risk management process consists of a series of steps, such as identification, analyzing, assessing, treating, monitoring. By implementing risk management organization can reduce unexpected and costly problems.

The main focus of risk management has mainly been on controlling and compliance with regulatory framework.

During 2007-2009 a lot of banks had a problem with liquidity. It was evident that profitability of capital did not save the bank against bankruptcy. In respond was established the Requirements for strong liquidity risk management and new rations for liquidity coverage and Net stable fund, mainly by the Basel III regulation. Based on the regulations the banks have to develop plans for risk situations, set of tools of all supervisors when bank is in breach of prudential requirements. The risks in Banking other than liquidity are credit risk, interest rate risk, market risk, operational risk. Liquidity risk of banks arises from funding of long term assets by short term liability, thereby making the liability subject to refinance risk or possibility that an institution may be unable to meet its maturing commitments or may do so only by borrowing funds at prohibitive costs. Credit risk is potential of a bank borrower or counterparty to fail to meet its obligations in accordance with the agreed terms. In other words, credit risk can be defined as the risk that the interest or principal or both will not be paid as promised. Interest rate risk arises when the net interest margin or the Market value of equity of an institution is affected due to changes in the interest rates. The interest rate risk has impact on the earning of the bank, liabilities and off balance sheet. Market risk results from adverse movements in the level or volatility of the market prices of interest rate instruments. In the financial market, bond prices and yields are inversely related. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Insurers are usually affected by material operational risk exposure, which may reach the same scale of other risk types such as insurance market and credit risk, depending on the specific business. The internal model approach under Solvency II requires a model – based quantification of operational risk for insurance and reinsurance companies.

Historically insurers have attributed company failure to underpricing, under-reserving, under-supervised underwriting, irresponsible management, reinsurance abuse. This is because operational risk losses are the result of complex interaction among risks derived from business process.

In the past, companies have not collected operational risk data properly or across the full spectrum of their business activities. Consequently, the Solvency II regime presents a number of challenge and difficulties for insurers and reinsurers alike.

Solvency II rules introduce prudential requirements tailored to the specific risks which each insurer bears. They promote transparency, comparability and competitiveness in the insurance sector. The frame work consists of a Directive (Solvency II directive became fully applicable to European insurers and reinsurers on 1 January 2016). The Directive covers capital requirements, risk management and supervisory rules.

According to Directive the Insurance companies have to put in place an adequate and transparent governance system and conduct their own risk and solvency assessment on a regular basis.

Both banks and Insurers are subject of industry consolidation and globalization, competing in same markets, e.g. savings. Focused on cash flow the difference between them is that Insurer's assets are funded to term while banks need to chase financing continually. The possible factors that can jeopardize the liquidity position in insurance are the Increase of lapses of life policies, default of bond issuer or credit risk and financial market crises. Banks focus primarily on current costs against known revenues and the tenure of their products is generally much shorter than an insurance company's.

The insurance company is solvent when its own resources achieve the amount of the capital requirement. Solvency regulation in the insurance industry also develops operational risk measures. Basel II provides three pillar approach including capital ratios, supervisory procedures and ensure market discipline and transparency.

Basel II introduces operational risk in the bank requiring measuring, managing and capita allocation in order to calculate operational risks. It also provides metrics that are considered operational risk such as liquidity, credit, interest rate, market risk. Banks and insurers have to comply with Basel II and regulators.

Banks and insurance companies dominate each financial services industry. The major banking groups hold mainly household assets in form of personal deposits and saving and the insurance market is considered to hold an important role in contributing in

taxes with most of households using insurance. So both industries are dominated by the management of risk in their daily operations.
The insurance companies risk is linked to the assessment of premiums and manages their investments on the financial market, while the banks are more exposed to liquidity risks. Nevertheless, both sectors are involved in risk management encounter similar types of daily operations in their businesses.
The Basel II and Basel III Regulations demand better disclosure to ensure effective market discipline and transparency, thus concentrating upon capital rations and supervisory procedures. The largest current issue for banks and insurance companies' arise e in operational risk and it remains under development. The insurance companies usually learned experience from banking sector implementing Basel II compliance process, thus finding compliance with Solvency less problematic. The Solvency regulation includes requirements for institutions to address and analyze the risk in order to assess risk management. In implementing Solvency II, insurance companies may learn from the difficulties experienced by banks in developing strategies with aim to develop a more in-depth understanding of the issued from Basel II implementation.
In terms of the management of risk, although the banks and insurance company may differ, the fundamentals of operational risk remain comparable.

Conclusions

Because taking risk is an integral part of the banking and insurance sectors both have been practicing risk management ever since there have been banks because the industry could not have survived without it.
It is important that in order to manage the efficiency of company and avoid financial failure or bankruptcy, the companies should identify poor liquidity management, tolerance for investment risk and governance issues.
Banks and Insurance companies must accept risk, manage risk and recognize them as real if they are to meet an economy's needs.

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