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The largest risks facing the international banking system

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Contents

Abstract

While financial institutions exploit globalization in the banking system, a natural byproduct of this expansion, the increased risk, affects the internal and external environment of banks and enhances banking probability of failure. This happens because of the fact that every operational activity undertaking by a bank, regardless rate of uncertainty, is associated with some form of risk (Lartey, 2012). The aim of this paper is to indicate the major risks facing international banks, such as: credit risk, liquidity risk, systemic risk, interest rate risk**,** political risk, market risk and operational risk. While each of them is considered to be manageable, together they represent a clear and present danger to the international banking system (Kirke, 2011). Therefore, to confront those risks, it is suggested to provide a more systemic solution rather than a separate one. There is a call for a global policy to deal with this project as long as the existing risk-specialized policies proved to be insufficient in addressing the main risks in the international banking industry.

Keywords: Banking, Risks, Globalization, Crisis.

1.0 Introduction

The concept of international banking system confronted several obstacles across all markets to finally reach the today's level. In the beginning, it has to face the fact that each nation was in a different economic phase (underdeveloped, emerging and developed economies). Indeed, Jesswein (2006) highlighted the relation between financial development and banking growth, referring that much of the countries' development happened in accordance to banks' ability to provide trade financing, credit, and foreign exchange services, activities specifically designed to overcome many of the impediments to conducting trade and investment transactions that cross political and economic borders.

There are many ways which banks develop globalization through their operations. First of all, national banks join partnerships with local banks abroad seeking to access clientele from other countries. Such tools are lending and borrowing money. When banks lend to each other globally, these loans are draining throughout corporate and individual customers among countries, whilst it is very common for banks to raise funds internationally for their operations through borrowing (Tebogo, 2012). Conventionally, banks have used the deposits they received from their customers to fund their lending activities (Lartey, 2012).

As it seems by the aforementioned facts, banks have to continuously strengthen their global position so as to become more competitive. Bolt and Tieman (2004) referred that such an increased competition, followed by rigorous capital adequacy requirements in the banking industry, often lead to riskier bank behaviors. For example, when banks have to choose between making higher profits and tolerating a higher risk of failure, they usually decide to worsen the quality of theirs loan portfolio. However, maintaining a high level of meager loans in a bank portfolio threatens banks' lending opportunities to a very large extent (Lartey, 2012). Moreover, all banks regardless of their type are identical in nature and exposed to the same

form of risks, meaning that the failure of one bank affects the others (Boyd et al, 2009). Thus, it seems quite logical why today's global banking system concerns about risks and seeks ways to deal with them. This paper discusses the most important risks facing the global banking industry and focuses on the various ways which banks implement, or should implement, to control these risks.

2.0 Facts and issues

During the growth of international banking, institutions and regulators collected information and made analysis mostly about the behavior of international banking. Tebogo (2012) referred that the outcome of those efforts was the generation of game theory models which showed that risks were eminent in international banking even if those which were considered very unlikely to materialize. However, globalization and the big exposure to improbable situations increased risk for financial institutions around the world and developed unimagined difficulties. In the meantime, the banking system continued to operate with the same principles developed decades earlier despite the indications of risk mutation. Unfortunately, the consequences of the recent crisis were dramatic for the financial system, as many banks and credit institutions collapsed by the contagious phenomenon. For example, more than 160 U.S. banks failed in 2008 and 2009, while only 11 banks failed between 2003 and 2007 (FDIC 2011), resulting in the establishment of a new U.S. federal agency, the Financial Stability Oversight Council, charged with monitoring and mitigating risk in the financial system (Hu et al., 2012).

3.0 International Banking Risks

The financial institutions have to overcome many challenges which are separated into various categories and levels of risk. The major risks confronting the international banking system include: credit risk, liquidity risk, systemic risk, interest rate risk**,** political risk, market risk and operational risk.

3.1 Credit Risk

Credit risk arises when a party to a contract fails to fully discharge the terms of the contract. Due the fact that this phenomenon was in a rising route, Basel I primarily focused on credit risk, where banks and financial institutions were required to maintain capital levels equal to 8% of risk-adjusted assets (Kirke, 2011). Thereinafter, Basel II has revealed numerous loopholes in accurately managing credit risk during the financial crisis. However, recent history showed that many financial institutions underestimated that danger. The culmination of this was the collapse of Bear Stearns and when Lehman Brothers defaulted on its debt and swap obligations (Ouamar, 2013). As a result, Basel III had to provide more effective regulations about addressing credit risk. Particularly, it determined several shortcomings and ambiguities present in Basel II such as enhancing capital for counterparty default risks inherent in structured financing transactions and over the counter (OTC) contracts or securitization transactions (Ouamar, 2013).

3.2 Liquidity Risk

Liquidity risk arises when bank has to meet its obligations as they come due, without incurring losses. There are two types of liquidity risk: funding liquidity risk and market liquidity risk. The first one occurs when a firm is unable to obtain sufficient funds to meet cash flow obligations; whereas market liquidity risk is the inability to conclude a large transaction near the current market price (Lartey, 2012).

Due the fact that a low liquidity ratio in one financial institution could affect the entire system, liquidity risk management is considered to be a subject of great interest for the regulators (Skoglund and Chen, 2012). In practice, liquidity risk has to be managed in addition to market, credit and other risks. For example, the Bank of Lithuania has established more than one parameter for Lithuanian commercial banks to comply with; the liquidity ratio, the liquidity buffer, the survival period and the net funding gap (Jasienė et al., 2012). Similarly, Khan (2012) demonstrated that liquidity risk may be minimized by enhancing domestic banks size and minimizing debt to equity ratio.

3.3 System Risk

Systemic risk occurs when the financial system undergoes contagious failure following other forms of risks. Most financial crises have resulted from systemic risk leading to the crunch of the whole system. For example, Sheu and Cheng (2012) proved that the sector-specific idiosyncratic risk dramatically affected the systemic risk of the whole financial system in Taiwan.

Recent literature review and empirical studies have shown that there are models of networks for the purpose of analyzing systemic risk. As Garratt, Mahadeva & Svirydzenka (2011) refer, these models fall into two categories. The first ones reviewed in International Monetary Fund (2009) and aim at simulating financial stress across the network. The latest generation of these models is influenced by the financial crisis and features sophisticated transmission through funding and fire-sale externalities and not just through chains of credit tightening (Gai and Kapadia, 2010).

3.4 Interest rate risk

Interest rate risk arises in the banking system when financial institutions act as asset transformers, i.e., they lend out long-term and refinance short-term. History has shown that interest rate risk played an integral role in crisis situations as the US Savings and Loan Crisis of the 1980s, where more than 550 of approximately 4,000 savings and loan institutions failed (Entrop, Wilkens and Zeisler, 2009). However, Basel I and Basel II Committees did not publish mandatory capital requirements for interest rate risk in the banking books. Basel III sets out the requirements that an authorized financial institution, with approval to use an internal model for interest rate risk in the banking book, must meet for regulatory capital purposes (APS 117). Each bank:

- Should have a framework to manage and monitor interest rate risk in the banking book according to the nature, scale and complexity of the institution's operations.
- Should have approval from regulation authority to use an internal model for determining the institution's capital requirement for interest rate risk in the banking book.

3.5 Political risk

Political risk has an adverse effect on any economy, mostly because it affects international banks' behavior. As Lartey (2009) refers, political risk constitutes the major constraint on foreign investment in emerging markets. It is quite obvious that an unstable political environment underlies higher banking risks in relation to a constant and continuously developing political system. An unstable political environment includes policy changes and change in taxation policies and law and other problems like public interest litigations, which subsequently hamper the production of goods or services rendered or the confiscation of assets of the business (Prakash, Joseph and Frederick, 2011).

Certainly, there are other factors which interact with political risk and in many cases mitigate the consequences. For example, when Ballester and Wezel (2008) examined whether the financial linkages of Latin American banks with other countries are influenced by political risk and deposit dollarization, he concluded that an increase in country risk is shown to be associated with a build-up of foreign positions by the banking sector. However, this adverse effect on the banking system is mitigated in economies with a high share of dollarized deposits.

3.6 Operational risk

Operational risks comprise of risks not included under the previous categories, but are still faced by the banking system; they are usually separated into internal and environmental risks. Internal factors include losses caused by inefficient management, by physical causes, by personnel failure, from liability for accidents, and due to mismanagement of business affairs (Bhushan and Maheshwari, 1997). To manage internal risks, it is required to develop a modeling approach that can measure the impact of operational decisions (Shah, 2002).

On the contrary, environmental risks include risks emanating from factors that the bank does not have control over such as fraud, natural calamities or terrorism (Tebogo, 2012). Diamond & Dybvig (2000)

analyzed the consequences of such "environmental risk" event of the World Trade Centre in the US referring that the resulting panic had a wide effect on the banks involved by depleting money reserves and threatening financial security in terms of diminished liquidity. Environmental risks should be considered at a portfolio level and banks should avoid overexposure to particular industries sensitive to environmental pressures.

3.7 Market risk

The market risk in the banking sector arises from the uncertainty of the effects of changes in economy due to change in various aspects of the market that affect earnings and stock prices of different banks in a similar manner. Most banks manage market risk with a short-term focus, attempting to avoid portfolio losses on a daily basis. However, the best practice for estimating the market risk is to adopt measures as Value at Risk (VaR) and Expected Shortfall (ES). VaR is a tool to predict the greater loss less than the certain confidence level on a specific portfolio of financial assets over a period of time. Fadhila and Rizal (2009) proved with their study in stocks of Bank Mandiri, Bank BRI and Bank BNI in 2009-2011, that financial institutions and investors are encouraged to use historical simulation to estimate VaR of asset return. The ES approach provides advantages relative to the VaR approach in terms of lower portfolio downside risks. Ho, Cadle and Theobald (2007) used ES framework to provide a reasonable solution to the asset allocation problem for bankers and investors. Particularly, they focused on asset allocations during the recent 'credit crunch' period and were able to develop insights into portfolio selection and downside risk reductions during high volatility periods.

4.0 Recommendations

Banks, investors, analysts and regulators seek solutions to effectively manage the risks facing the international banking system. However, it is quite difficult to efficiently forecast all dangers in the banking

industry and, subsequently, to minimize their impact on bank operations. In addition, these dangers facing international banking system are complex and intertwined, which means that even if there is a solution to one risk, there will be possibly an adverse effect on the others.

Consequently, the plausible solution requires the collaboration of all parties including authorities, agencies, banks, governments, corporations and even the people themselves (Kirke, 2011). First of all, the supervisors of financial institutions should continue to support the idea of adequate capital to cover all risks. There is also need for international policy coordination among monetary, micro-prudential and macro-prudential policies (Lartey, 2012). Banking risks include many categories, as credit risk, liquidity risk, systemic risk, interest rate risk**,** political risk, market risk and operational risk, which have already been analyzed in this research. Therefore, banks are required to form a special organizational unit in charge of each risk management category, which will be charged with the responsibility to prescribe procedures for risk identification, measurement and assessment, as well as procedures for risk management. To prevent the next crisis tsunami and to provide a longer-term solution, it requires a previously massive restructuring of the present banking system.

5.0 Conclusions

The international banking sector made a remarkable flourishing during the last decade, as it is considered to be the workhorse in flowing funds from one country to another. Along with the development of the banking industry, risks continue to pose a hazardous situation for the risk managers working on them. Because of the connected system of the international banking environment, a failure in one country can now cause a domino effect in several countries (Tebogo, 2012). For example, Greek banks are planning to sell their mortgage, consumer and business loans to foreign credit institutions. The reason is that they want to clean up their portfolios from the "red" loans, as well as to bring balance between loans and deposits.

Nevertheless, such practices involve a passing risk from one bank to another with limited knowledge of the possible outcomes.

The paper examined the major risks facing the international banking system and analyzed the impact of those risks on banking operations using examples of the real world. Such risks are the credit risk, liquidity risk, systemic risk, interest rate risk**,** political risk, market risk and operational risk. Moreover, it provided measures used to control them or minimize their affection to bank operations. Last, it recommended greater collaboration among banking supervisors to ensure prudent monitoring, risk management and crisis management.

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