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Bank Risk Management Strategies and Tools from a Developing Country Perspective: Case for Uzbekistan

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Abstract

Banking system is still an accumulative force for fueling the economic growth and financial sector development, although the series of harsh conditions are obscuring the advancement by different dangers, risks and long-lasting problems. Risk scenario for developed and developing economies' banking systems differs in risk-taking, risk appetite, absorption of loss and risk mitigation. This article examines the risk profiles, origins and management tools from a tailored perspective of international banking system and analyses how banking system structure and condition of Uzbekistan responses to the risks.
Keywords: Bank risk, monetary policy, global financial crisis, developing country, Uzbekistan.

1.Introduction

Risks management became a highly discussed topic in recent years, as news about numerous bank failures and bailouts keep dominating the media. Although banks and insurance companies have always been leaders in implementation of the most extensive and efficient risk management models, numerous weaknesses of risk management were exposed during the subprime crisis (Oblakovic, 2013). Modern banking practices are far reaching than traditional banking which sought profit from receiving deposits and granting of loans - today only one part of a typical bank's operations, and they often less profitable. Contemporary banks are large investors who have significant positions and operations in financial markets. They have a broad market orientation of both financial services markets and financial markets: marketability of banking services and bank assets, securitization and derivatives. Complicated spectrum of banking activity and extended profit horizon, in turn, have faced the wider risks from both markets. Globally banks are realizing that they need a more pragmatic approach for managing a growing plethora of risks enveloping the banking and financial industries landscape and have now understood the significance of risk management to sustain their organization (Vaidyula and Kavala, 2014).

There is a global concern that development of banking practices has the effect of concentrating risk and increasing volatility within the banking system as a whole. Banking system risk management policy has an apparent strategic importance for the economy. After global financial crisis bank risk management tools and strategies gained clearer focus and were revised in terms of relevance and consistency with changed global financial landscape. Failure of financial columns of international financial architecture – systemically important or too-big-to-fail banks have proven the alarming need for new approaches to bank risk-taking and exposure, assessment and management. Furthermore, polarization in banking systems of developed and developing economies in terms of operations, wealth and safety created a huge gap of potential risk profile, risk appetite, impact areas and conditions for mitigation. Interestingly, advanced economies with the most powerful and ruling banking systems were broken by financial system disorders in the first wave of the global financial crisis despite the availability of early warning signals, cushioning systems and safety nets for different risks. Banking systems in developing economies had more optimistic scenario of loss by global financial system, as they had limited participation in international financial services markets and financial markets. They survived under the shade of their own less developed banking systems and less shares in international capital flows.

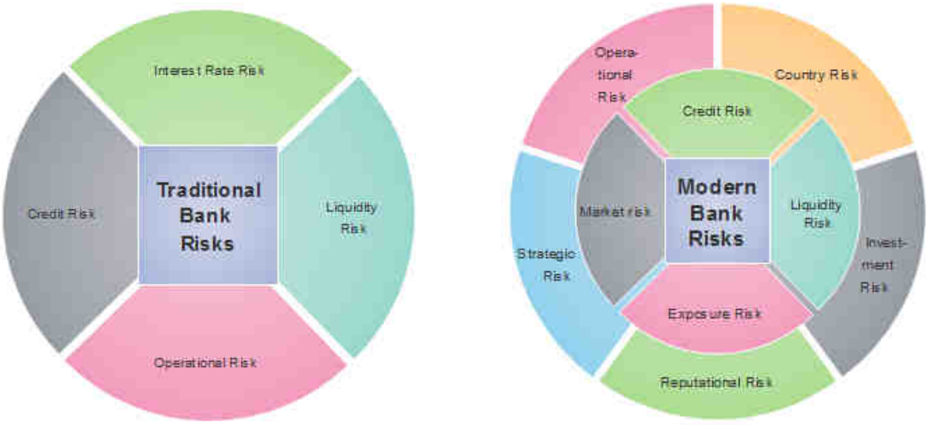
2. Literature Review

Bank risk management is an old topic of global economic debates to be discussed by academic rounds, experts of international financial organizations, policymakers and practitioners. Being a vital action to keep the global financial environment safe and sound, it has become a controversial research area since 1990s. However, risky profile of international banking systems implied the studying the recent literatures, as bank risk get complex and impossible to manage. Recent studies by Bülbül, Hakenes and Lambert (2013) two driving factors for risk management: bank competition and sector concentration of banking services markets push banks to implement advanced risk management. Empirical analyses of relationship between bank risk and monetary policy at whole by Altunbas, Gambacorta and Marques-Ibanez (2014) proved that unusually low levels of interest rates over an extended period of time contributed to an increase in banks' risk. Kanchu and Kumar (2013) concluded that the banks should take risk more consciously, anticipate adverse changes and hedge accordingly, it becomes a source of competitive advantage, and efficient management of the banking industry.

3. International Banking System Performance and Bank Risks: Changes, Challenges and Clues

As financial institutions have grown more complex, the demand for risk management has grown rapidly (BIS, 2009). Hence, risk management has become one of banks' main activities and can be seen as banks' core competence (Bülbül et al, 2013). Development in international financial markets and diversity of financial instruments facilitated wider access to funds for banks. The process did not slow as banks regularly involved in developing new instruments, products, and services. Due to acceleration of economic integration and creation of global financial chains, strengthening of capital interdependence and highly interconnected financial linkages, financial institutions enjoyed several channels of profit from different bank and non-bank activities till global financial crisis.

Figure 1. Bank risk spectrum



Source: Author's compilations, 2016

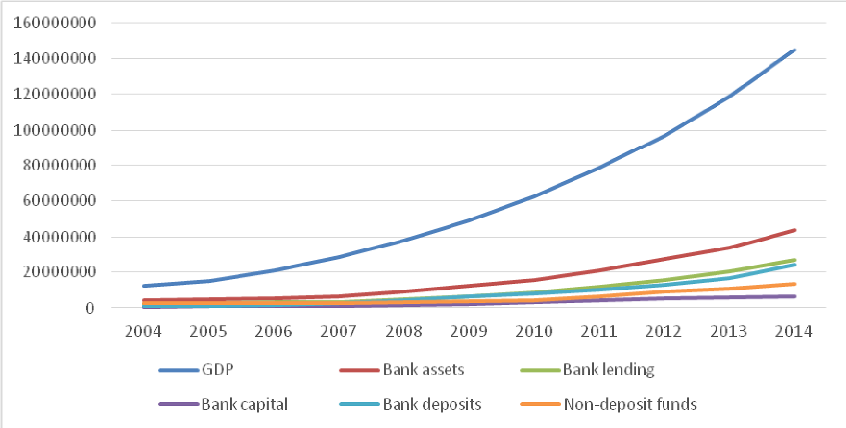
The run-up to the global financial crisis was marked by excessive risk taking in the financial sector, and once the crisis hit, the accumulated risks led to systemic problems and the failure of many individual financial institutions (IMF, 2014). Traditional view of bank risks changed and condition for banks to overcome risks have got tighter. Types, origins and factors of risks for banks increased in number and expanded in impact (Figure 1). Banks played the role of direct and indirect market maker in financial markets and influenced ob the movement and flow of investment in international scale which consequently led to the emergence of investment risk and brought the danger of bankruptcy and capital losses in recessions. On the other hand, financial innovations became the task force of driving the banking services market where brand management bears the reputational risk. Large volume of capital accumulation and extension of bank size caused the establishment of giant, too big to fail banks, who has an economywide impact and importance. Their operations in an economy posed the strategic risk in a double-edged character as can be seen in Lehman Brother's collapse.

Current banking practices show that banks should continuously analyze major risk factors which may affect their financial operations, revise their organizational structure and improve processes for managing relevant risks to ensure that they have effective risk management mechanisms. In order to avoid credit risk, banks should clearly specify the credit approval process, credit policy, credit risk rating, diversification of credit portfolio and criteria for loan repayment ability of a customer. In order to mitigate market risk, banks are advised to monitor the influence of risk factors such as monetary policy orientation and changes, volatility of foreign exchange rate, and to ensure the availability of instruments to hedge from losses. Liquidity risk is recommended to managed by diversification of sources of funds through says and repurchase agreements in international money and capital markets considering market conditions. Operational risk can be dealt with defining, assessing, monitoring, mitigating and controlling risk.

4. Conditions and Environment for Bank Risks in Uzbekistan:

Banking system of Uzbekistan has been performing comparatively well despite harsh conditions two periods of crises (Abdullaeva, 2015). Cross-border effect of global financial environment sometimes affects the banking system soundness and performance. However, regularly rapid economic growth and favorable macroeconomic condition enables the banking system to adopt the full market principles in the financial sector. Many studies found that macroeconomic condition in the economy has direct and collateral effects in emergence of risk for banking system performance. Moreover, in line with macroeconomic policy, bank-specific policies also influences on the riskiness of operation and conditions for banks. In Uzbekistan, banking system is the core, as the financial system is bank-based which shows that capital in the economy is concentrated in banks, while in advanced economies financial markets deal capital movement and allocation which are seen as the cause of global financial crisis. Along with macroeconomic policy, bank risks root from banking system performance, structure and principles. Conditions in the banking system play the key role in risk encountering and risk taking. In the context of Uzbekistan, macroeconomic condition, economic growth, financial system and banking policy create risk-isolation condition for banks with growing economy, banking environment and liberalized capital movement (Figure 2).

Figure 2. Banking system performance in Uzbekistan in 2004-2014, mln UZS



Source: Central Bank of Uzbekistan, 2004-2014

Banking system indicators ensures a clearer view of bank risk taking and risk appetite. Regulatory and supervisory observations of the Central Bank are also directed to identify, monitor, analyze and mitigate the risks potentially faced by the entire banking or financial system. Its control over money supply, inflation, interest rate, exchange rate and bank performance targets the risk-free environment for banks. Money supply management by Central Bank regulates the inflation and ensures a stable purchasing power of national currency in domestic market (Figure 3). Consequently, income evasion from inflation decreases and savings of individuals and firms increases, banks gain wider lending and deposit offers. Another risk management action of the Central Bank is the regulation of key interest rates for banks and other non-bank financial institutions. Setting interest rate ceilings and floors in consistent with macroeconomic condition enables banks to operate in less riskier environment and helps to control the capital volume and movement in the economy (Figure 4).

Figure 3. Money supply management through sterilization in 2014-2015, billion UZS

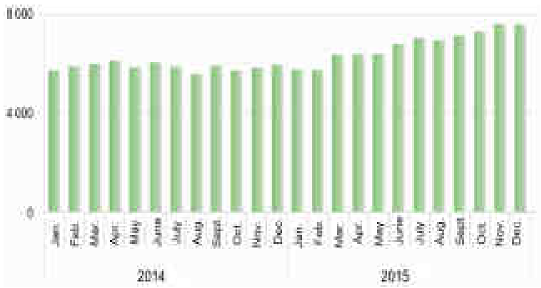
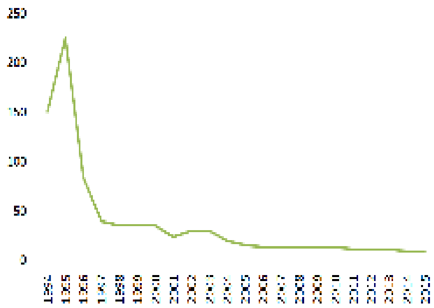


Figure 4. Refinancing rate in 1994-2015, %



Source: Central Bank of Uzbekistan

Historical evidences proved that monetary policy is the key factor to secure banks from external shocks and systemic crises which initially originated from improper approaches to existed risks and other hazards in many developed economies. Global financial crises and its long-term implications still dominate in international banking practices, since international organizations and central banks of several countries proposed recovery programmes. Common feature of recovery proposals was the creation of macroprudential policies and newly adopted early warning signals which reflect the risky condition in banks. Cross-border effects of financial shocks and all waves of global financial crisis could not affect the banking system of Uzbekistan negatively due to prudential macroeconomic and monetary policy which clearly outline the risk frontiers and stimulate the risk-secured banking performance. Higher-than-standard banking sector indicators and regulatory improvements enabled banks to cushion the potential risks.

6. Conclusions

This small-scale study presents the clearer view of bank risks at international and a country levels with comparisons and assessment of conditions for risk taking. Findings of cross-border analyses reveal limitations and obstacles to manage risks, volatility and uncertainty in global banking environment, cross-border and market-led effects of global financial crisis in banks. Deriving from the key findings, following conclusions and empirical recommendations for international banks are drawn:

1. Imposing additional loss absorbency requirements for systemically important banks;
2. Imposing floors for banks capital when they invest, as insufficient capital can be a risk factor;
3. Reducing the organizational complexity at large banks and revising bank-specific aspects of relations with affiliates and subsidiaries, as mismanagement and data asymmetry in decision-making may cause greater risk;
4. Modifying the stress test models in accordance with market conditions and financial profile, as properly organized stress test may show the weaknesses of banks clearer;
5. Ensuring transparency and accuracy in reporting, as misreporting may bring risks;
6. Monitoring the lending operations and keeping the optimal allocation of loans among types and sectors.

In the context of progressive banking system of Uzbekistan, banks are required to run a prudential policy to keep the bank and the system stable. Abovementioned theoretically rooted empirical recommendations may fit to Uzbek banks depending on the conditions. However, as many international financial organizations recommended, running macroprudential policies for banks and creating early warning signal systems for each bank in order to identify the risk, its scope and potential impact areas.

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