In this article how risk management in banks is an important concept, what type of risks banks faces and how they curb it through risk management model is described.

Managing the Risks of Financial Innovations in Banking

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Source

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Abstract

With the subprime crisis, people are paying more and more attention to analyze financial innovations and manage the risks. In this paper, firstly, we discuss the effects of risks, which may bring adverse or harmful impacts to us, and then we define the risks of financial innovations in banking, which are mainly market risk, credit risk and operational risk. Next, we study ways to calculate market risk, credit risk and operational risk, respectively. Finally, we analyze the effects of regulations in managing risks of financial innovations in banking. From our analysis, we find that people can take out countermeasures to assess and manage risks of financial innovations in banking to avoid or reduce losses.
Operational risk arise due to the modernization of banking sector and financial markets which gave rise to structural changes, increase in volume of transactions and complex support systems. Operational risk cannot be categorized as market risk or credit risk as this risk can be described as risk related to settlement of payments, interruption in business activities, legal and administrative risk. Financial innovation is the act of creating new financial instruments as well as new financial technologies, institutions, and markets. Recent financial innovations include hedge funds, private equity, weather derivatives, retail-structured products, exchange-traded funds, multi-family offices, and Islamic bonds (Sukuk). The shadow banking system has spawned an array of financial innovations including mortgage-backed securities products and collateralized debt obligations (CDOs). Despite the innovations in the financial services sector, credit risk is still the main cause of banking problems. The reasons for the emergence of credit risk may be bad faith of the borrower, deterioration of the competitive position of a particular firm, an unfavorable economic situation. The basis for reliable management of reliable risk management is the definition of existing and potential credit risks inherent in credit operations. Managing and controlling risk. Although a few failures are the product of fraud, the key risk in banking remains credit risk—the risk that a borrower will default. If too many customers default, so does the bank itself. Historically, the best tools to manage credit risk included a strong reliance on understanding the business prospects of the borrower and the sources of repayment. This evolution, in turn, and the related financial innovation and widespread use of complex derivative and securitized investment products, have required virtually all banks to know more about the management of market risk. Put somewhat differently, in the past few years, banks have initiated transactions with higher risk and used new financial engineering techniques to lay off or hedge that risk.