

RISK MANAGEMENT - A PART OF BANK MANAGEMENT

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Abstract: *Every economic activity involves a risk, but the bank's activity is the most risky because it's based, mainly, on promises and prognostications regarding the businesses of the lended customers. However, the banks are the most prosperous institutes in the world. The secret is an adequate risk management. The responsibility of the bank's management is infinitely larger than the management of an ordinary company, through the impact which the crash of a bank may induce in the economic, financial and social life of the region where the bank is carrying it's activity.*

Short history

Banks emerged in Romania¹ early from second half of nineteenth century, helped by Romanian and foreign capital.

Although attempts have been made earlier, it is only after The Participates Union when Romanian Savings Bank, Farmers Credit Bank and a monetary system were established.

National Bank of Romania (NBR) is founded in 1881 from private and institutional capital.

Starting 1991, along with the restructure of Romanian Economy, the reform of banking sector has gradually taken place to insure the banks, including National Bank the role and place on the market economy.

Commercial banks currently operate according the Law of Commercial Firm number 31/1990, republished in 1998, with subsequent amendments in Banks Law no. 58/1998. According to the Banks Law, banks can only be established as joint stock companies, authorized by NBR, with social capital submitted entirely on cash. The minimum amount is settled by NBR.

Bank Functions

Banks insure² the financial and banking intermediating between the debtors and creditors. They are the main element of the financial system with the roles of financing, deposit collection and payment means management.

As main financial intermediates, banks perform a vast range of banking activities and operations offering their customers a complex and divers portfolio of banking and products services.

Basically, banks work with "other people's money". Theoretically, according to the Basel Comity regulations, the degree of adequacy of the requested capital is approximately 8 percents. Practically, congenial to NBR regulations, banks that operate in the Romanian market are requested an adequacy degree equal to 12 percents, higher than international standards. This is due to the higher risk associated with the transition markets.

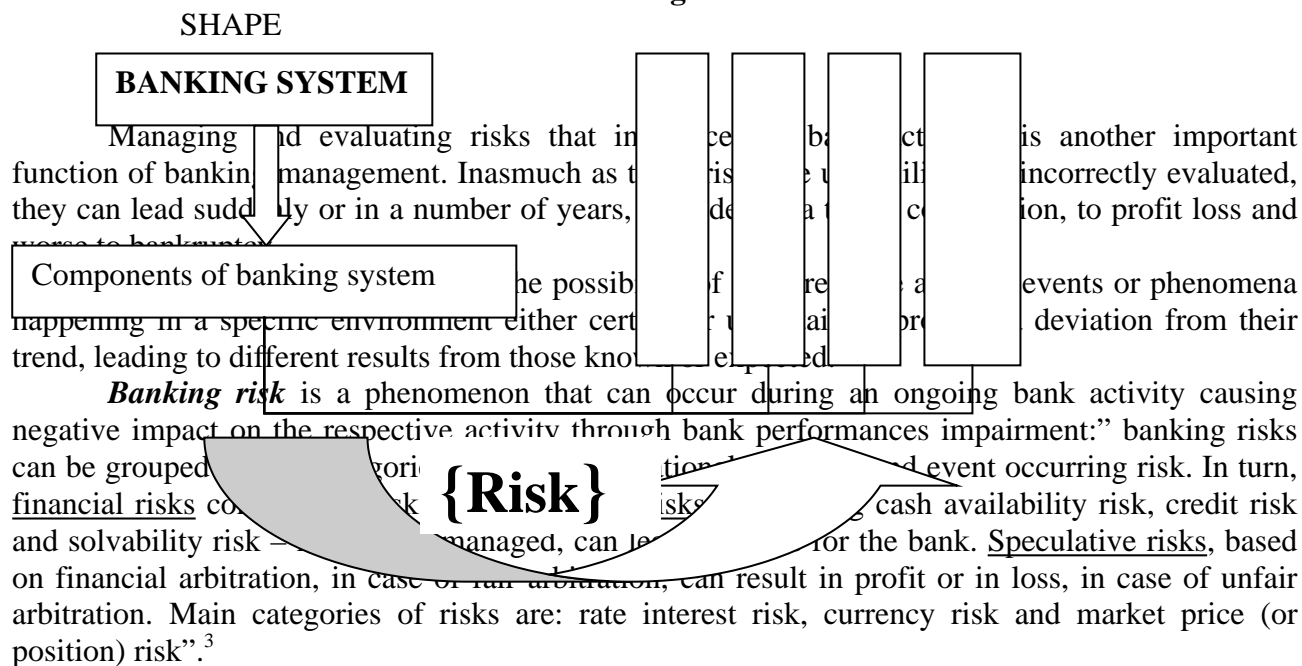
Practically, this means that one bank is operating approximately 90 percents of the attracted capital as reserves and on sight or term deposits. Hence, banks as an infinitely greater number of customers than a commercial company of the same size. The success or failure of a bank can, directly or indirectly, inflict a larger customer segment that might loose their money, savings, business, etc. than the bankruptcy of a company from any other activity domain.

The present techniques and methods of banking management are grouped in five process management fundamental elements (figure 1).

¹ **Ilie Mihai**, *Banking operations technique and management* Expert Publishing House, Bucharest, 2003, page. 47

² **Cezar Basno, Nicolae Dardac, Constantin Floricel**, *Currency, credit, banks*, Didactic and Pedagogic Publishing House, Bucharest, 1999, pag. 59

Figure 1.



Risks are inertial in banking activity and the objective of risk management is not to eliminate them but to manage these risks.

Bank risks management can be defined contextually as the sum of methods, techniques, programs used to prevent and diminish these risks.

Bank management and the risk

Precautions against risks are however are common to any managerial policy. Consequently defining the fundamental objective of banking management from the risk perspective actually involves the precautions that a bank’s manager (one activity’s owner) is taking in order to protect the bank against a loss situation occurrence.

The concept of **risk** can also be defined as an engagement that holds an uncertainty due to the win/loss probability. Etymologically, the term of risk descends form the Latin “re-secare” meaning breaking off the equilibrium.

Risk handling is the key function of modern banks focused on market activity.

Managing a bank means to manage that business and also to manage the risk. An efficient risk management implies a **separate management** of business and risks.

For shareholders, customers and for whole economic and social activity, limiting the risk specific to banking activity is a management activity concern, but also a consequence of this activity.

In this direction, we can notice an increase of concerns both to identify and to handle the operational risk, the reputation risk, the legislative risk and also the risks associated to integration processes.

At the EU level, among these risks associated to integration processes we can enumerate:

- **Strategic risk** which supposes the risk of losing the customers and/or the personnel and implicitly lowering of sales, as a result of the fact that they disagree the new policy of the group;
- **Operational risk**, as a result of IT system integration;

³ **Hennie van Greuning, Sonja Brajovic Bratanovic**, *Banking risk analysing and management. Estimate of corporate leading and financial risk*, IRECSO Institute, Bucharest, 2004, page 12.

- **Legislative risk**, the result of the need of legislative harmonization towards the integration on one hand and as a result of the need to protect customers' business on the other.

The precautions against risks are common elements to any managerial policy.

In order to develop the integrated management of risk, scoring techniques, internal ratings and of credit risk and capital allocation models as well, EU countries authorities and concerned with stimulating banks to:

- Create databases for managing credit loss history
- Properly forecast of credits, considering the economic cycle.

Basel accords⁴

Basel I, issued in 1988 by Basel Committee is insured in Romania through NBR regulations number 8/1999 concerning limiting the credit risk of banks. The agreement stipulates how to calculate the solvability indicators and capital adequacy rates based on the weighted assets with for main risk categories: 0%, 20%, 50% and 100%. Hence the first aspect that led to the necessity of the Basel II Accord, namely the rigidity of solvability indicators estimates⁵. Moreover other Basel I weaknesses have been noticed such as risks standardization, overlooking individual risk profiles, depending on the business⁶.

Nowadays, in Romania, the solvability indicators are estimated using Basel I accord, only evaluating the credit risk. In the developed countries, the market risk evaluation is considered when calculating the solvability indicators.

Basel II Accord is required for a better evaluation of risks that banks assume and for adding the operational risk to the equation⁷. Bank restraints, especially Romanian banks, come from the fact that for calculating these indicators there must be installed certain databases built in a period of several years. Basel Accord provides the emerging economy countries with a possible transition period of maximum 3 years to apply.

For the first risk category, the **credit risk**, concerning the Romanian banks especially, Basel II provides a number of calculation options. **The standardized approach** basically implies that the calculation is made depending on the weighted assets risk by using risk weights similar to the present ones but that will depend on the ratings conferred by external institutions. **IRB base approach** (*Internal Ratings Base Approach*) relies on banks' internal rating and enables them to calculate the non-payment probability, other indicators (resulted loss from non-payment and non-payment exposure) being supplied by NBR. As per the market risk – the most difficult to evaluate on the present Romanian banks⁸, Basel II largely copies, with small changes, the 1996 amendment used by the banks in developed countries. The advanced IRB method asks the banks slightly reduced capital requirements rather than standardized methods.

An exclusive innovation is solvency indicators computing also considering the operational risk⁹. For us the innovations are those previously mentioned plus the market risk estimate. Through NBR regulations no. 17/2003, it is requested that banks evaluate the market risk exposure of the market value and to compute the market risk exposure at least daily. Nowadays, from the solvency

⁴ The Basel Committee on Banking Supervision is an international committee of representatives of banking supervisory authorities and central banks from the main industrialized countries which activates in quarterly meetings held at the Bank for International Settlements in Basel: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

⁵ **Market Watch IT&C Magazine “Basel II Accord”** - Arion Negrila, March 2005, page 21.

⁶ **Market Watch IT&C Magazine “Basel II Accord”** - Arion Negrila, March 2005, page 35

⁷ **Ibidem**, page 38

⁸ **Ibidem**, page 21

⁹ **Ibidem**, page 22

indicators' point of view, the Romanian banking system sits comfortable: the average is 20%, against the minimum of 12% as requested by NBR. Credit portfolio growth must be considered since, according to Basel I accord, has an average risk greater than 90%. In the next period of time banks will focus on credit portfolio growth. Also, a reduction of banks' solvency indicators and these will still start from the premise that they sit comfortable from the NBR requirements' point of view – 12% capital adequacy payment. If we also consider that NBR or European Union might request us to also include the operational risk, there will be reasons to concern about the compliance with the request to fit within the minimum level of 12%.¹⁰

The main objective of the new Accord is that *to evaluate and establish the minimum capital of banks* depending on the key elements of banking risk and stipulates that the banks should be granted incentives in order to improve measurement techniques and management of banking risks. **Minimum capital rate of the bank** is to be computed by the formula:

SHAPE

In drawing no.1 ca Total capital ted, comparatively, the Basel I requirements and those of the new project Accord Basel II. ≥ 8

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Pillar no.1: Minimum Capital Requirements – quantitative approach of disclosure requirements

Advanced and flexible rules to determine the minimum capital requirements for:

- **Credit risk**
 - Standardized approach
 - Internal models based approach (IRB): a) base option; b) advanced option.
- **Market risk**
- **Operational risk:**
 - Base indicator approach
 - Standardized approach
 - Advanced estimate approach.

Pillar no.2: banking supervisory of capital – qualitative approach to prudential requirements.

- Supervisory Authority active role in assessing bank internal procedures for capital adequacy in relation to risk profile;
- Banks' internal procedures are supervised by the supervising authority;
- The imposed requirement that banks should hold capital in excess of the minimum from Pillar 1;
- Implementation of an early stage intervention mechanism for NBR

Pillar no.3: Market discipline – necessary instrument in supervisory disclosure.

Further detailed reporting requirements for NBR and, recently, for the public, concerning:

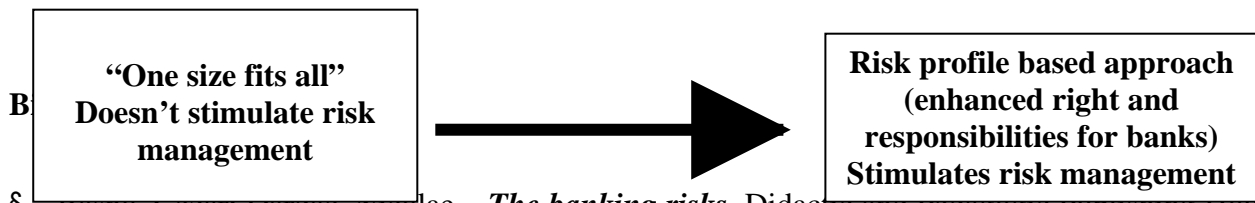
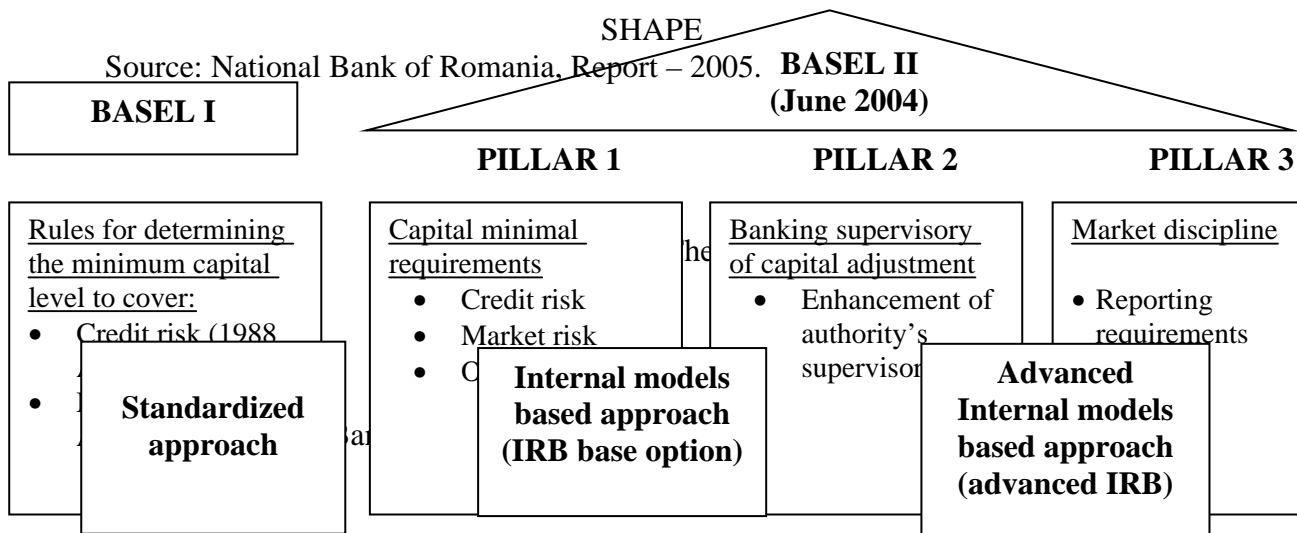
- Shareholders' structure;
- Risk exposure;
- Capital adequacy to risk profile;
- Credit risk

Synthetically, we will present the methods and requirements of the new Accord regarding risk level adjusted assets. There are 3 options: one standardized approach and two internal rating based approaches (see drawing no.2).

¹⁰ *Ibidem*, page 24

Risks limitation is done through regulations established by each bank, but also through measures settled by the regulatory authority opposable to all banks. Agreed risk boundaries are being revised periodically depending on new trends and aspects.

Drawing no.1 Capital Accord dynamic



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****The Banking law no. 58/1998* – Official Monitor of Romania no.121/23 march 1998.