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RISK MANAGEMENT – IMPORTANT COMPONENT OF THE STRATEGY OF COOPERATIVE BANKS

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Abstract

In the context of macroeconomic uncertainty problems existing on international markets, expanding the banking system leads to amplification interferences of a broad spectrum of risks. This article delineates the recent area of researches interest in the domain of credit risk management in banking.

Key words:
Banks, cooperative banks, risk management, financial markets, aggregate risk

1. Introduction

Risk management is an important component of the strategy of a cooperative bank to obtain a desired level of profit while maintaining an acceptable risk exposure.

Risk is the fundamental element that drives financial behavior. Without risk, the financial system be vastly simplified.

However, risk is omnipresent in the real world. Cooperative banks, financial institutions and credit institutions, therefore, should manage the risk efficiently to survive in this highly uncertain world. The future of banking will undoubtedly rest on risk management dynamics.

Only those cooperative banks that have efficient risk management system will survive in the market in the long run.

2. Strategy of risk management in cooperative banks

Despite the positive developments observed at the macroeconomic level, the banking sector in Romania recorded deterioration in financial results in 2014, these being placed in negative territory, as in the previous years (except 2013). This trend continued in 2014. Combined financial result recorded a loss more than 2.5 billion lei in 2014. It is the biggest loss suffered by the banking system since the crisis began, this being the result of the explosion of bad loans that reached a share of over 20% at the end of 2014. In general, positive financial results were achieved by large banks that have costs associated with relatively low credit risk and an improved operational profitability. Operating income showed a negative trend throughout 2012 and 2014, due to unfavorable developments in net interest income. The provision expenses continued in 2014 to represent the largest expenditure category of the credit institutions.

Transition to IFRS implementation by the credit institutions as the basis of accounting and for filling in the financial statements from 1 January 2012, was made in order to maintain an adequate level of capitalization and provisioning by introducing prudential filters. Romania is committed to the agreements concluded with the international organizations to maintain continuously an adequately the level of prudential banking indicators.

The latest results exercise of stress testing the banking system solvency, covering a two years horizon, show an ability to maintain good credit institutions, at an aggregate level to withstand macroeconomic shocks. However, a small number of credit institutions show an increasing vulnerability due to induced effects on net interest income and also to higher financing costs, and the increased volume of provisions due to weaker market value of the collateral and the deteriorating quality loan portfolio. Under the circumstances of an adverse scenario, characterized by a strong depreciation of the national currency, and the return to recession, the reduction of the solvency ratio of the banking system in Romania would be about 2.5 percentage points to about 15.3 percent. In addition, deterioration of credit institutions operating profit amid lower demand for new loans would impose resizing their work in order to reduce the share of fixed costs in the total of their operating expenses.

To meet these challenges credit institutions must have policies and procedures to limit and control risks, and their measuring system must consider all significant sources of risk, taking into account the interdependencies between different types of risk. They must also be able to assess the impact that changes to income risk play both the bank and the market value.

The central topic of the paper, the risk, can be defined as a multidimensional concept whose level cannot be reduced to a single element or a single number. For each banking sector it is important to determine an acceptable level of risk. It is closely related to the maximum loss that a credit institution can sustain, being absolutely necessary to improve its work. There is no single acceptable level of risk. This differs depending on the dissimilar development of each economic activity and the appetite that the decision maker has for risk.

The term banking risk defines those risks faced by credit institutions in their current operations, not including the time only specific banking risks. However, even if we talk about some risks faced by other companies in the course of their work, how these risks affect the credit institutions is specific for the banking activity. General banking risks are part of banking risks, due to the specific way in which they affect banking activities (Pretescu, I, 2005). Moreover, these risks are taken into account when talking about risk prevention and monitoring set by supervisors to ensure that they will not have a significant impact on the economic environment.

Credit risk can have a significant impact on credit institutions. It can be direct, when not managed properly and becomes loss, or may be indirect, with negative results on customers, employees, business partners, or even on the banking supervisory authority. Credit risk may arise from within the institution, driven by exposure to customers, or beyond, coming from the external environment. Credit institutions are also subjects of all the risks the customers are facing, risks that can be extremely diverse.

The literature in the field of banking highlights directions for the development of risk management and bank performance in recent years focusing on banking risk management in crisis conditions. In addition, the importance and complexity of banking risk management, the rapid development of methods and techniques of management and, not least, the emergence of new types of banking services and products that have exposed the credit institutions and cooperative banks in particular the growing risks diverse and complex, requiring an update of the topic, taking into account the specifics of the banking sector in Romania and the reform in this sector.

In the activity of credit institutions are identified five major risk categories, namely:

- credit risk,
- market risk,
- liquidity risk,
- operational risk
- reputational risk.

These types of risks are not excluding each other, given the fact that a product or service can expose the credit institutions at multiple risks.

The credit risk is the risk of record loss or failure to accomplish estimated profits due to non-fulfillment from the counterparty of its obligations stated in the contract.

In terms of economics, risk is defined by three main activities, namely:

- the analysis activity, which requires accurate estimation of risk based on customer's initial status parameters and of the transaction for which funding is needed.
- the risk prevention activity to diminish or even remove the effects.
- the ownership of costs activity and potential loss diminish generated by risks.

Credit risk strategy objectives and the associated risks are:

- increase in loan portfolio quality of the credit institution by monitoring the following indicators:
  - the importance of "overdue" credits and that of "doubtful" credits in total loan portfolio (gross value) not to exceed 2%;
  - the importance of "overdue" credits and that of "doubtful" credits in total equity (gross value) not to exceed 5%;
  - the importance of classified credits into the "doubtful" and "loss" categories (gross value) in total loan portfolio not to exceed 5%.
- maintaining a net interest margin percentage resulting from dividing the active average interest rate to the liabilities average interest rate of minimum 1,5.

For the credit risk strategy, the credit institution seeks the review of lending requirements whenever is needed by internal and external regulations and through which is to be studied:

- analysis of used terms;
- analysis of approval and granting of the credit criteria;
- analysis of credit guarantee policy and of the evaluation practices of securities;
- diversification of loan portfolio by products specific to every type of customer;
- updating of rules and regulations relating to lending activity
- review the rules and procedures for managing non-performing loans;
- developing and improving IT applications and communication system for the provision of credit and interest overdue reports;

– pursuing unpaid overdue loans and interests by using different methods (negotiating with the client, the rehabilitation credit and the prosecution, enforcement);

– offering credit insurance so that the risk is transferred partially or entirely from the creditor;

– compel the applicants, co-payers and guarantors to engage in credit and other payment obligations arising from all these with all their movable or real estate property;

Interest rate risk is determined and monitored to calculate the potential adverse impact on net interest income, as a result of improper correlation of interest rates on attracted and borrowed sources with interest rates on investments made and the potential losses in net assets.

The levels and dynamics of the interest rate are the result of simultaneous action, converging and contradictory, of several general and specific factors with direct or indirect influences such as: the profit rate, the ratio of demand and credit supply on the market, the risk for loan provider, the duration of the credit, purchase price for attracted sources, volume of owned sources which are not invested in fixed assets, level of inflation, monetary policy, etc.

Minimize interest rate risk depending on the ratio of interest bearing assets and interest bearing liabilities, taking care that its value is close to 1.

The current period is called "risk management era" in banking, and risk management is an extremely complex and important banking management. Risk management involves prevention, measurement, risk management and control. This is achieved through commensurate efforts and quantify them one of the ways the calculation of risk indicators, which enables static and dynamic assessment of the risks, with reference to international standards in the field or historic bank experience.

Risk indicators are more relevant in a general context for assessing bank profitability and its competitiveness in the market, the ultimate objective of bank management; consisting of maximizing the market value of the bank, influence risk -adjusted returns to shareholders.

Certainly there are a great number of models for credit risk management structure generated by a portfolio of credit but this is not what we need to present further but a few requirements that must be met by compiling a model institution banking under Basel II.

In the international financial crisis and as a result of the research, the Romanian banking system can be characterized by a comfortable level of solvency and liquidity, while observing deterioration in asset quality and recording a modest profit as a result of stagnation in lending. However a number of measures to improve risk identification and monitoring were imposed by the central bank:

a) Developing, completing and reviewing the rules, policies and procedures for internal auditing CDD, internal and external fraud;
b) Change computer systems through the development and implementation of automated applications.
c) Improve the risk management and setting thresholds which risks are significant;
d) Review of credit policy, setting concentration limits by type of credit facility cease providing unsecured, improving tracking and realization of the revaluation guarantees, develop or improve procedures for the sale of receivables, credit risk assessments under alternative scenarios for crisis conditions, compliance with the maximum permitted large exposure;
e) Review the liquidity risk management policies, improve liquidity crisis management strategies, liquidity indicators once defined the bank's risk profile, the emergence of new alternative financing arrangements for providing liquidity needs in times of crisis;
f) Improving assessment tools exposure to operational risk, completion indicator system of operational risk;

Also to improve the "health" of the banking system stability requires further structural reforms both at the micro and macro level. Such central bank has proposed a series of reforms in this regard:

- Prudential supervision through the establishment of the European Systemic Risk (European Systemic Risk Board - ESRB);
- Prudential supervision through the establishment of three European Authorities for the supervision of individual financial institutions (European Supervisory Authorities -ESA) and the formation of the European System of Financial Supervisors (European System of Financial Supervisors - ESFS).

The complexity of the credit cooperative operations which generate the need for daily labor monitoring and risk management as an essential condition for the continuation of the parameters of normality.

In the market economy, globalization, liberalization and diversification of financial markets, fierce competition between the credit institutions and many of the products and services offered by them are the main factors that have exposed the banking sector to new risks, while leading to multiple challenges. For these reasons it is becoming increasingly important both permanent innovation and risk management techniques tools as well as banking performance. Only a pertinent analysis and a very good knowledge of the new tendencies in banking financial risk management can provide credit institutions in Romania efficient options on their use of management, while obtaining a higher profitability and an adequate level of liquidity.

3. Conclusion

The reputation of a cooperative bank is very important for clients. A corporation seeks to develop relationship with a reputable banking entity with a proven track record of high quality service and demonstrated history of safety and sound practices. Therefore, it is imperative to adopt the advanced Basel III methodology for credit risk.

For banks in Romania with the "emerging markets" tag attached to their gain down the Basel III path could be an effective strategy to compete in very complex global banking environment.

Romanian banks need to prepare themselves to be competed among the world's largest banks. As our large banks consolidate their balance sheets size and peruse aspirations of large international presence, it is only expected that they adopt the international best practices in credit risk management.

A cooperative bank's success lies in its ability to assume and aggregate risk within tolerable and manageable limits.

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