



Assessment of Performance and Risk in the Banking System in Romania

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ABSTRACT

The banking system is characterized by multiple dimensions of financial risks that affect performance. Both credit institutions and financial institutions need to improve their risk management understanding and practice in order to successfully manage their entire business. Changes in the financial and institutional sphere have contributed to an increase in financial instability, generating consequences at two different levels: firstly, it has led to a rise in credit risk, and secondly it has raised concerns in the area of banking risk management through the emergence and expansion of performing techniques of risk management, evaluation and protection.

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1. Introduction

In order to identify, assess and manage the risks specific to banking activities, a prime role lies in the models and techniques that address operational risk and liquidity risk, with an emphasis on their behavior in times of economic and recession. Particular importance is given to the CAAMPL (Shareholding Active Management Profitability Liquidity), operational risk reporting models, stress-testing methods, and the alternative financing plan for liquidity risk management, taking into account the recommendations of the Basel Committee (Directive CEBS on the management of concentration risk in the supervisory and review process, December 2009).

2. Operational risk

Operational risk generating events occur both as a result of the influence of internal factors such as the nature of banking activity, organizational structure, human factor, organizational changes, inadequate performance of internal activities, and external factors such as economic conditions, changes in the banking environment, technological process, changes in legislation, taxation, competition, robbery, falsification, breakage of codes related to information systems, use of advanced technology that may affect the achievement of the bank's objectives.

Due to the continuous development of the economy, the globalization and the expansion of economic activities, the international financial market as well as the European market is in a complex and continuous process of adapting products and services, as a result of the existing competition.

Under these circumstances, operational risk has become an increasingly important element for credit institutions, which are forced to redefine their own products and services in order to strengthen their market position and penetrate new markets and, on the other hand, due to the increasing use of innovative financial products (e.g. secured products, credit derivatives, structural products).

The Basel Committee defines operational risk as the risk of loss due to inadequate or defective internal processes, by people and systems or by external events, focusing on the causes of losses to differentiate operational losses from losses from other risk categories. In order to remain on the market, financial institutions have to comply with the standards and regulations in force, and must anticipate market developments and be responsive to significant factors that influence market dynamics in order to be competitive and profitable.

In order to notify operational risk events, management analyses address the manner of reporting events which generate operational risk and how performance indicators are calculated. After identifying EROs (Errors specific to Operational Risk), the territorial units will register them in an Operational Risk Recordbook and transmit them according to internal regulations to the territorial units that in turn transmit them to the functional entity in the central administration responsible for managing the event of that operational risk category. The data for the calculation of the performance indicators are obtained on the basis

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of the information in the database created and managed at the central level, which includes operational risk events identified and notified by the functional entities in the central administration and the territorial units.

The table below reflects the risk appetite in terms of operational risk indicators (Directors' Report of the Romanian Commercial Bank on the Financial Year 2013).

Table 1

Indicator	Risk appetite
Operational risk	Provision sufficient capital to cover the expected and unexpected losses. The level of the target (target) should be set so that the bank can comfortably cover operational losses and remain within the desired risk appetite. A target limit of 500 million RON is set for the capital requirement for operational risk. In March 2013 it was 469 million RON.

BCR's operational risk profile is average considering the following:

- ✚ Continuing the reorganization and restructuring process carried out within the bank, regarding the process of crediting to the clients of SMEs, which implies the modification of the related systems, the procedures and fluctuation of the personnel registered during such transformation periods;
- ✚ Implementation of the IT solution for real-time validation of certain types of transactions in the bank's basic application.
- ✚ In order to reduce the exposure to operational risk, the bank's operational risk strategy for 2013 considered the following priority directions:
- ✚ Establishment of BCR Operational Risk Committee - as the only forum for analyzing the main operational risk issues and establishing the necessary measures with the involvement of all responsible entities;
- ✚ Implementation of appropriate procedures / norms / working instructions to prevent / limit operational risk and to improve the internal control system;
- ✚ Centralizing the drafting of loan agreements and guarantees related to bank loans to corporate customers as well as the archiving of original documentation under the new Credit Management Project;
- ✚ Improving the risk assessment process for new products.

3. Liquidity risk

Liquidity risk is the risk that the bank's liabilities can not be met when they mature or can be performed at a non-economic price, or an asset cannot be sold due to a lack of liquidity in the market.

In BCR, the liquidity risk is defined in accordance with the principles established by the Basel Banking Supervision Committee. Thus, a distinction is made between the market liquidity risk, which is the risk that BCR can not easily offset or eliminate a position at a market price due to market failures, and the liquidity risk of financing, which is the risk that BCR cannot efficiently perform current and future cash outflows, both expected and unexpected, as well as collateral needs without affecting daily operations.

The liquidity risk of the funding is further divided into the risk of insolvency and the structural liquidity risk. Insolvency risk is defined as the risk that in the short term current and future obligations cannot be met in full or in a timely manner in an economically justified manner, while the structural liquidity risk is the risk of long-term loss due to changes in refinancing costs or margins.

Obtaining liquidity implies for the bank, on the one hand, an increased effort in general to improve all performance and performance indicators and increase all sides of its image. On the other hand, banks must make a special effort to improve the determination of resource requirements as accurately as possible by means of foreseeable calculations, able to reflect the magnitude and regularity, to determine the modulated evolution of the requirements for the money market.

All this leads, in fact, to an important way of increasing the bank's ability to gain profits and increase its performance. This requires bank management to address three aspects of liquidity risk, protect against liquidity risk, measure liquidity risk, and manage liquidity risk.

Liquidity analysis requires banks' management not only to analyze their liquidity situation on an ongoing basis, but also to examine how funding requirements can evolve in various situations, including unfavorable conditions.

In its cash oversight activity, the Basel Committee has focused on how banks generally manage their liquidity. Technological and financial advances have provided banks with new ways to fund their business and liquidity management. Due to the fact that standard bank liquidity management practices have changed since the publication of the study "A Liquidity Analysis and Management Framework" in September 1992, the Basel Committee issued a new study (BIS Principle 3 and 7, Principles for Sound Liquidity Risk Management and supervision - BCBS, September 2008). It sets out some principles that highlight the key elements of effective liquidity management. The form and complexity of the process used in liquidity management depends on the size and complexity of the bank and the nature and complexity of its business. Although the study focuses on large banks, the principles have a broad applicability for all banks.

In particular, good information management systems, analysis of net funding requirements in various alternative scenarios, diversification of sources of funding and the provisioning plan are important elements for sustained liquidity management in a small bank or a bank which is active in fewer markets than large and complex banks.

In the event of a liquidity crisis, pressures are short-term. For this reason, BCR decided to implement a standard short-term liquidity limit at the group level. The short-term limit refers to the 5-day net flow that must be covered by the freely eligible collateral, separately for each major currency: local currency (RON) and EUR. There are two criteria of major importance to be taken into account in the daily calculation of collateral value for the short-term liquidity limit. These two criteria are: the availability and eligibility of the securities. The short-term liquidity limit must be calculated and monitored daily for each of the two currencies, RON and EUR.

There are five liquidity scenarios on each asset and liability balance sheet:

- Normal working conditions (CNA / Ordinary Course of Business): There are no internal or external problems;
- Individual crisis (CI / NameCrisis):
 - A light - moderate individual image crisis (CIU / Mild Name Crisis): Decrease in profit and / or negative outlook;
 - Serious – severe individual image crisis (CIG / Severe Name Crisis): Decrease of the rating with at least two units;
- Market Crisis (CP / MarketCrisis):
 - Mild Market Crisis (CUP / Mild Market Crisis): Slight recession, mild political crisis;
 - Severe Market Crisis (CGP / Severe Market Crisis): crisis in the banking sector, a long and serious deep recession.

In order to measure liquidity risk, a new model of analysis based on these scenarios has been developed, which shows the bank's ability to cope with different types of liquidity crises. This provides a dynamic picture of the bank's liquidity according to the different scenarios for the liquidity crises, but also the time horizon for the analysis.

According to the principles BIS 3 si 7 (BIS Principle 3 and 7, Principles for Sound Liquidity Risk Management and supervision - BCBS, Septembrie 2008) the senior management of a bank is responsible for developing and implementing a liquidity risk management strategy in line with the risk tolerance defined in the bank. A bank's executive board must review and approve this annual liquidity strategy.

In the table below, the risk appetite is reflected in terms of liquidity risk indicators (Directors' Report of the Romanian Commercial Bank on the Financial Year 2013).

Table 2

Indicator	Risk appetite
Credit - deposits indicator	Funding is a strategic element that ensures the BCR Group's liquidity position. Therefore, the loan-to-deposit ratio at BCR Group should not exceed 150%. This limit should remain applicable also in adverse situations or periods of significant business growth. BCR has to continue its efforts to materialize the increase in funds from the deposits of local clients.
Analysis of the survival period (SPA)	The bank must have funds at any time. As a result, BCR wants to carry out its work at a level that will allow it to cope with any stress test scenario for a period of 1 month according to the SPA concept. The survival period for May 2013 was 12 months for RON and 1 month for the euro.

BCR's liquidity risk profile is prudent due to: BCR's ability to attract liquidity through treasury operations, external financing, capital markets, etc., including from the parent bank; The steady volume of resources attracted from customers due to the extensive network of territorial banking units; Maintaining a significant portfolio of government securities; The Group's commitment is to maintain its exposure for Romania;

3. Concentration risk

Concentration risk refers to potential adverse consequences that may arise from concentrations or interactions between similar or different types of risks or between types of risks such as the risk arising from the requirements of the same customer, of a related customer group, of goods and services, as well as the credit risk arising from the use of risk spreading techniques, and in particular from more indirect exposures.

Concentration risk is the exposure that may arise from the uneven distribution of assets either within the same type of risk or between different risk categories within the institution and which may potentially cause large losses that may affect the stability of the institution or the ability to perform the underlying transactions; A material change in the institution's risk profile.

Intra-risk concentration pertains to the concentration risk that may arise from the interaction between different risk exposures within a single risk category;

Inter-risk concentration pertains to the concentration risk that may arise from the interaction between different types of exposures within different risk categories. Inter-risk concentrations may also occur when exposures to a counterparty or group of counterparties are not recorded in the same place. When risks have a common determining factor leading to concentration, the correlations between risk exposures that are supposed to be low may materialize to a high degree in times of stress.

For the purposes of assessing the level of concentration risk, a semaphore warning system shall be used, depending on the value of the Gini-Struck coefficient.

If the level of significance is exceeded, appropriate measures should be taken, such as: reducing loan finance for a given portfolio area; Reducing a certain type of collateral accepted to finance the loan; Stricter monitoring of certain types of collateral; The in-depth review of the borrowers' economic performance; Stronger monitoring of customers in that portfolio area; Portfolio diversification to other business lines; The periodic review of credit risk mitigation techniques, their value and the possibilities of their execution.

4. The risk from securitization

Represents the risk arising from securitization activities / operations initiated / issued by the bank which do not run according to expectations or where a counterparty fails to fulfill its contractual obligations. The securitization risk may arise from the transfer of insignificant credit risk, market innovations in this area, implicit residual risks, the provision of implicit support for a securitization, early retirement options (clean up call option) or an early repayment. The securitization risk was assessed as immaterial, as the Bank is not currently involved in such operations.

By securitization, the mortgage loan portfolio is taken over by a specially set up vehicle company that will issue shares or bonds on the basis of the loans.

5. Reputational risk

Reputational risk refers to potential adverse effects that may arise from the negative reputation of the bank. The bank's reputation refers to its public image (investors / creditors, employees, clients, etc.) in terms of competence, integrity and trust.

BCR's reputation risk profile is prudent, based on maintaining the trust of the public and business partners in the bank's economic and financial standing.

6. Strategic risk

Strategic risk refers to negative effects on capital and profit as a result of decisions in business policy, changes in the economic environment, poor or insufficient implementation of decisions, or inability to adapt to change in the economic environment.

It is the risk that usually occurs due to competition. An example of such a risk could be the following situation: the relative disappearance of the traditional market of large loans and low risk for companies and their replacement with trade effects.

Another example of the strategy's risk is when a bank is not prepared or unable to compete in a new activity. For example, in the internet banking business, BCR delayed this process and therefore could not gain a competitive advantage in this area. This conservative attitude of waiting for the market to develop itself is a risk.

7. Macroeconomic risk

Macroeconomic risk represents the current or future risk of negative return on profits and capital as a result of unfavorable developments of the main macroeconomic variables or of any variables that are targets of the economic policy of the country in which the credit institution is operating.

8. Conclusions

The risk can have a considerable influence on a credit institution, both an influence that is felt in the direct losses recorded, as well as an influence whose effects are felt on clients, staff, business partners and even on the authority of the bank.

Taking into account the experience gained in running the business, banks agree that the most important cause of the loss was the excessive concentration of risk on a customer, industry or economic sector, country.

Losses by banks arise due to excessive lending to customers or excessive engagement in some speculative activities.

Banking management should monitor both the performance of the banking institution, namely banking profitability and liquidity risk. There is close interdependence between bank profitability and liquidity, depending on the bank's ability to create liquidity and the ability to place it on the market, directly influencing the bank's profitability.

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