THE STRATEGY FOR EFFICIENT MANAGEMENT OF SIGNIFICANT RISKS IN THE COOPERATIVE BANKING SYSTEM DURING THE CURRENT ECONOMIC AND FINANCIAL CRISIS PERIOD

Carmina Elena CONSTANTINESCU[1]
Liliana-Aurora CONSTANTINESCU[2]

***Abstract**: In recent times, there has been a special emphasis on the efficient management of risk while maintaining reasonable performance (not maximizing performance) in credit institutions. Considering the emergence of the COVID-19 pandemic at the global and national levels, the conditions for the depreciation of debtors' (customers') repayment capacity and the increase in associated default risk have been triggered. This necessitates the periodic analysis and mutual agreement with debtors to establish methods for debt recovery and their repayment terms, aiming to reduce credit risk. The investigative process involves studying literature in the field at both national and international levels, using practical skills and the experience gained by a large number of credit institution managers, as well as the practical elements acquired by the author in her role as head of the credit department at Cooperatist Bank Unirea Brașov.*

***Key words**: banking system, risk, the COVID-19 pandemic, economic crisis;*

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1 Head of Credit Department, Cooperative Bank Unirea Brașov, email: carminamihai@yahoo.com ;

2 Dimitrie Cantemir Christian University, București, email: lilianauroracon@ yahoo.com

1. Introduction

Starting in 2020, the global banking system began facing new challenges caused by the economic and financial crisis initially triggered by the Covid-19 pandemic and further exacerbated by the effects of the Russo-Ukrainian war. The precise understanding of clients and the impacts felt in their businesses could influence credit institutions in making the best decisions for the continuity of their operations under performance conditions.

Due to the cooperative business model, cooperative banks have been at the forefront in providing support to their members and clients to facilitate their navigation through the crisis caused by the Sars-Cov-2 virus. Like all other banks in Europe, cooperative banks assisted their clients with payment deferrals, followed by public and sectoral moratoriums. In the year 2022, they continued to be a support for their clients affected by the economic and social effects of the Ukraine war, offering ongoing payment deferrals, attractive interest rates, and continuous assistance.

The European Association of Cooperative Banks has emphasized, during the years 2020-2022 in discussions held, the need for special regulations for the cooperative banking system, especially regarding their capital and liquidity, as well as supervision and risk mitigation processes. It is more important than ever to consider the specific business model and structure of cooperative banks in the measures taken by the European Central Bank or the European Commission, and these banks should benefit from support. According to statements from members of the European Association of Cooperative Banks, (EACB, ANUAL REPORT, 2022), constructive dialogues are being conducted with European supervisory authorities in this regard. The association has called on the legislative and regulatory apparatus in European countries to adopt pragmatic approaches in the upcoming period for the risks of cooperative banking activities, as it is clear that the emergence of this virus has generated a crisis with financial implications that are not fully understood.

The primary objective of the European Association of Cooperative Banks is to explain not only the significant role of cooperative banks in the EU but also what they have already achieved and what they can accomplish as catalysts for recovery and economic growth both during the pandemic and after the SARS-COV-2 virus-induced crisis and during the crisis generated by the war in Ukraine. Moreover, if the crisis of the years 2020-2021 equally affected both the commercial and cooperative banking systems, facing similar difficulties, during the economic and social crisis in the year 2022, the cooperative system was much more affected, especially the networks of cooperative banks in neighboring countries with Ukraine, including Romania, Bulgaria, and Hungary.

The strategy for bank risk management has undergone significant changes due to the challenging period it is going through. As a result, banking institutions are required to adopt new measures to address banking risks and support the economy on one hand, and their clients on the other hand.

2. Literature review

In general, risk refers to future events that can cause a certain loss. It can be predictable when the factors leading to losses can be anticipated in advance, and unpredictable when generated by unexpected situations. Modern financial theory nuances this definition, considering that an equivalence between probability and risk should not be assumed; "probability is, in fact, the unit of measurement for risk and a means of quantification for it." (Constantinescu, 2018).

In his doctoral thesis, economist Hadrian Silivestru asserts that „until the '70s, it was considered that the relevant banking risks, impacting banking activities, were credit risk and risks within payment systems. After this period, seen as an important moment in the development of the banking risk concept, credit institutions faced new challenges, having to manage an increasing number of new forms of risks." (Silivestru, 2010). In the Concise Oxford English Dictionary, risk is defined as "hazard, the possibility of a negative consequence, loss, or exposure to chance" (Concise Oxford English Dictionary, 1995).

A proper risk management should ensure the bank's ability to identify and assess banking risks, control them, eliminate or avoid them, and finance them when necessary. (Roxin, 1997)

In recent times, credit institutions have faced increasingly greater risks, adopting new techniques for their management. Specialized literature in recent years sequentially addresses banking risks that can directly affect credit institutions and indirectly impact their partners, including clients, monetary authorities, and employees.

Internationally, various approaches to modeling credit risk are employed. These can be classified into two categories, namely unconditional models that consider only information about the debtor and/or the credit instrument, and conditional models that take into account the influence of macroeconomic factors, including the level and trend of inflation, unemployment, the financial situation of economic sectors, and stock prices. Moreover, certain credit risk assessment models also differ in terms of the chosen time horizon and the measurement of credit loss through default-mode or mark-to-market approaches.

The main models used for credit risk management include:

- CreditRisk+ (developed by the investment bank Credit Suisse First Boston)
- CreditPortfolioView (developed by McKinsey & Company)
- CreditMetrics (developed by the investment bank J.P. Morgan)
- PortfolioManager (by Moody's KMV)

The Basel Banking Supervision Committee has developed agreements over time that encompass regulations, limits, and more concrete risk surveillance measures specific to banking institutions. These are designed to assist banks operating internationally in formulating a strategy for bank risk management. The objective of these measures is to enhance the banking sector's ability to absorb shocks arising from financial and economic crises, regardless of their source. This, in turn, reduces the risk of contagion from the financial sector to the real economy. The latest Accord, also known as Basel III, consolidates the following components of the regulatory framework:

- Improving the quality of banks' regulatory capital by placing greater emphasis on the continuous loss-absorbing capacity in the form of Common Equity Tier 1 (CET1) capital.
- Increasing the level of capital requirements to ensure that banks are sufficiently resilient to withstand losses during crisis periods.
- Enhancing risk capture by revising areas of the risk-weighted capital framework that have proven to be poorly calibrated, including global standards for market risk, counterparty credit risk, and securitization.
- Adding macroprudential elements to the regulatory framework by introducing capital buffers that accumulate in good times and can be drawn down during crises to limit procyclicality.
- Establishing a large exposure regime that mitigates systemic risks arising from interconnectedness between financial institutions and concentrated exposures.
- Specifying a minimum leverage requirement to limit the impact of excessive leverage in the banking system, complementing risk-weighted capital requirements.
- introducing an international framework to mitigate excessive liquidity risk and maturity transformation by implementing rules and standards for calculating liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) indicators.

While Basel III is approaching its final implementation deadline, the Basel Committee on Banking Supervision has continued to modify its provisions. In the financial community, these proposals have come to be unofficially known as Basel IV.

The purpose of the new Basel IV accord is to restore credibility in the calculation of risk-weighted assets and improve the comparability of banks' capital reports. To achieve this, it proposes a series of modifications, some highly technical, including:

- Improving the standardized approaches from previous agreements for credit risk, credit valuation adjustment risk, and operational risk. These rules establish new risk ratings for different types of assets, including bonds and real estate.
- Restricting the use of internal modeling approaches. This measure can contribute to ensuring a strong capital base and reducing the risk of regulatory non-compliance. Regulators may limit this by restricting the use of internal modeling and ensuring that banks use standardized approaches, as well as introducing new regulations and requirements for internal models. Regulators may also impose limitations on the quality and complexity of internal risk assessment models and ensure regular audits to ensure banks comply with these rules and standards.
- The leverage ratio would imply that globally important systemic banks must adhere to stricter limits on leverage usage. They should be limited to a ratio of own equity to own funds, depending on the bank's type of activity. For example, banks engaged in securities transactions should be limited to a leverage ratio of 15-20:1. This would limit the bank's ability to engage in large-volume transactions and mitigate associated risks. The new leverage ratio will require maintaining additional capital reserves.
- The limits imposed by the Basel agreements have brought significant challenges to the risk management of credit institutions, especially in the context of the economic and financial crisis caused by the COVID-19 pandemic and the conflict between Russia and Ukraine. Since 2020, banks worldwide have faced considerable pressures, and only a precise understanding of their customers and the impact felt in their businesses could influence credit institutions in making the best decisions to ensure business continuity under challenging performance conditions.

3. The Cooperative Banking System and Its Role in Supporting the Economy

Based on the sense of solidarity among cooperative members, with the motto "all for one and one for all," it was natural for the idea of cooperation to sometimes be associated with economic and social doctrines based on the concept of social solidarity. As organizations centered on the needs of their members and grounded in solidarity, equity, and mutual support, credit cooperative organizations constitute a factor in social stability and cohesion. They also serve as providers of financial and banking services, capable of making significant contributions to the attainment of millennium development goals, bringing about meaningful improvements in the living conditions of ordinary people. Credit cooperative organizations have two defining features:

- They are an economic system due to the activities they undertake, and even though they have a cooperative character, ultimately, they generate profit.
- They are a social system because cooperative members satisfy their own needs by cooperating in achieving the goals of the credit cooperative organization.

Credit cooperative organizations operate, as specified by legislation, "in order to fulfill their common economic, social, and cultural needs and aspirations," carrying out their activities "primarily based on the principle of mutual assistance among cooperative members" (constitutive act). In the economy, credit institutions exist not only to meet market demands but also as "actors," competitors in the market, "striving" to attract the market surplus (savings of individuals and legal entities), providing loans to individual clients, legal entities, and entities without legal personality, and conducting other operations to achieve performance and profitability (Constantinescu, L.A., 2018).

The banking system has a unique role compared to economic agents in other sectors, with banking development primarily providing the necessary structure for the functioning of the market economy. The existence of a competitive banking system must be based on efficient leadership, professionalism, effective and prudent risk management, and extensive transparency.

In Romania, the banking system (Constantinescu, 2011) is organized into two levels: at the first level is the National Bank of Romania, as the central and issuing bank, and at the second level are the credit institutions

In the 21st century, by combining economic, scientific, and political factors, and considering the crisis caused by the COVID-19 pandemic, leaders of credit cooperative organizations are the facilitators of changes occurring within the organization. It is the era of pragmatism, of adjustments awaiting the integration of performance in the cooperative banking environment. Four forces are stirring the world of economic actors as:

- Economic globalization;
- Disputes around power within the organization and the leadership methods involved;
- The revolution of information ;
- The exhaustion of old methods of productivity and performance.

In the current situation, leaders of credit cooperative organizations are aware that they are facing changes that traverse the organizations, requiring them to orient themselves in the following directions:

- Capitalizing on material capital;
- Amplifying added value and knowledge management;
- Defining a new relationship based on trust between employees, leadership, and the organization.

Due to the business model of the cooperative system, cooperative banks have played a leading role in supporting their members and clients, helping them navigate through the crisis triggered by the Sars-Cov-2 virus. Similar to other banks across Europe, cooperative banks have provided assistance to their clients with payment deferrals, followed by public and sector-specific moratoriums. In 2022, they have remained a steadfast support for clients affected by the economic and social repercussions of the war in Ukraine, extending additional payment deferrals, offering appealing interest rates, and providing ongoing assistance.

4. The strategy for the efficient management of significant risks in the cooperative banking system

To highlight the impact of the current economic crisis and the measures that could be taken by the cooperative system in Romania, we conducted a detailed analysis of managing specific risks within a cooperative credit organization, with a case study at Cooperative Bank Unirea Brasov.

First and foremost, I aim to analyze the strategy and policy for credit risk management, starting from the motivation given by the fact that granting loans represents the core activity of Banca Cooperatista Unirea Brasov. The granting loans involves assessing the credit worthiness of clients and their ability to generate sufficient income throughout the duration of the loan. The emergence of various factors can impact the economic situation of clients, representing the main reason why one of the unit's primary risks is credit risk, meaning the risk that the party receiving the loan may not fulfill contractual obligations. To prevent this from becoming a serious problem for the cooperative bank, it must identify non-performing assets at early stages, find recovery solutions, and establish reserves for such non-performing activities. Credit risk management involves a good understanding of the customer, closely followed by credit analysis. The principles underlying banking credit include:

- Banking prudence manifested as a result of credit requests by credit institutions during their operations. They aim for credit beneficiaries to meet conditions that categorize them into the low or medium-risk class, such as credit bureau history, work experience, job stability, owned properties, and others.

- Credibility of its clients. This constitutes the psychological element without which credit cannot be granted. Gaining trust involves understanding the client-member, whether an individual or the data concerning the commercial company, regarding moral and professional qualities, as well as reputation viewed through the quality of products and services, relationships with partners, and the financial and asset situation.
- Precise destination in the form of direct lending. Financial institutions grant loans with a specific purpose based on the clients' needs. There are loans that can be used without presenting supporting documents, as well as loans that can only be used according to the documents and their intended purpose at the time of loan approval.
- Loan collateral. Each loan must be secured either by personal guarantees or by movable and immovable property or securities in the borrower's assets in the case of a commercial company.

The bank's strategy regarding credit risk and associated risks aligns with the requirements of Basel III and takes into account the provisions of the National Bank of Romania Regulation no. 18/2009 concerning the framework for the management of credit institutions, the internal process for assessing the adequacy of capital to risks, and the conditions for outsourcing their activities, with subsequent amendments and completions. The lending activity must be constantly correlated with concrete measures to limit and gradually reduce the proportion of overdue loans in total placements, as well as to collect amounts due at maturity to ensure both an adequate quality of the loan portfolio and an appropriate level of liquidity. Additionally, abnormal trends in value adjustments related to loans are also monitored. In order to implement the strategy for credit risk, Unirea Brasov Cooperative Bank has established a series of limits: on specific banking products, on economic sectors, on geographical areas, on types of clientele, and limits related to residual risk. This credit risk management strategy includes strategic objectives, the credit risk strategy, and the policy for managing this risk. The specific indicators of credit risk have been analyzed during the period 2019-2022, resulting in a medium credit risk as of December 31, 2022.

Following the analysis of the loan portfolio (Fig. 1.1) and the analysis of impairment adjustments (IFRS) (Fig. 1.2), we identified various causes that led to the recording of an oscillating trend for the balance of placements during the analyzed period compared to December 2018 and a decreasing trend for adjustments, 0.87% lower compared to January 2018.

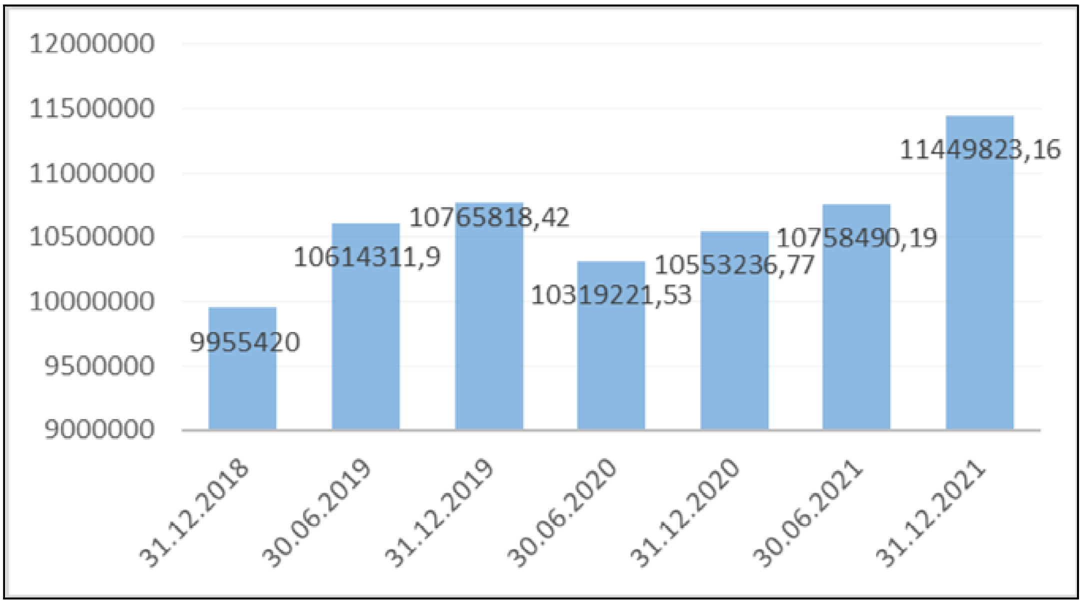

Fig. 1.1. *Evolution of the balance of placements (lei) at Unirea Brasov Cooperative Bank (source: compiled by the author based on data extracted from the archive of Unirea Brasov Cooperative Bank).*

The upward trend of the placements balance was interrupted in 2020 due to the consequences of the pandemic caused by the SARS COV-2 virus. An increase in adjustments (Fig. 1.2) and delinquencies is observed in 2020 when consumers faced difficulties in payment due to job loss or a reduction in income. Nevertheless, to protect the credit history of its customers and to assist them in mitigating the economic impact, Unirea Brasov Cooperative Bank allowed customers to defer their installments. All 103 requests submitted for this purpose in 2020 were approved. For recovery, ongoing within the Cooperative Bank, it is necessary to have careful and continuous monitoring of the granted credits to identify problematic loans or debtors facing financial difficulties in order to implement a restructuring scheme. Additionally, maintaining constant communication with the bank's legal executor is essential to improve the recovery of loans undergoing forced execution.

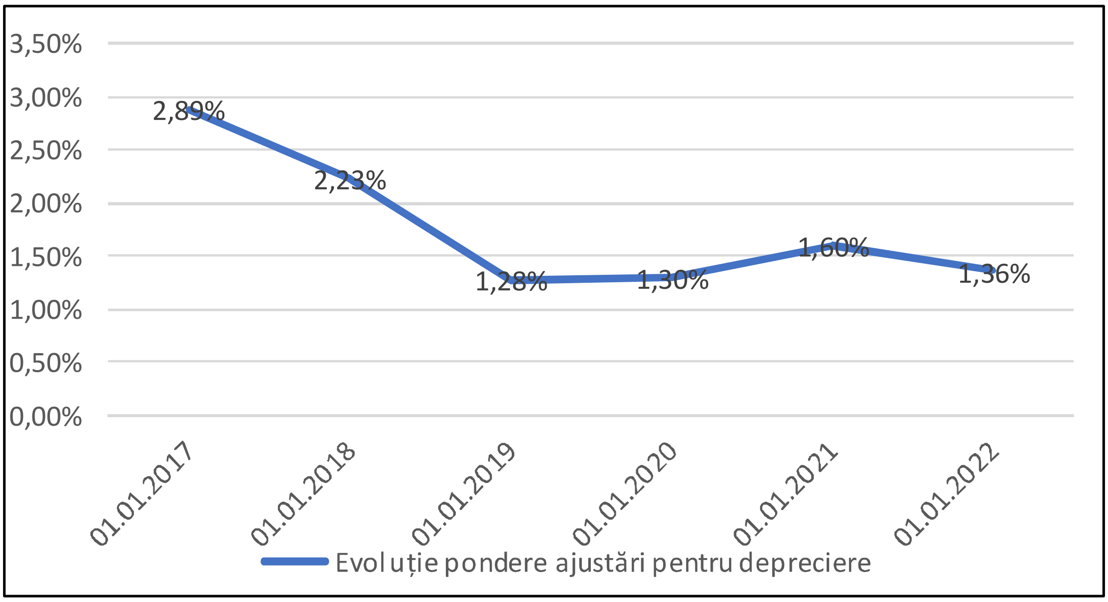

Fig.1.2. *Evolution of the impairment adjustment ratio related to outstanding loans during the period 2017-2021 (source: compiled by the author based on data extracted from the archive of Unirea Brasov Cooperative Bank).*

Following the analysis, I propose the following measures to reduce delinquencies and address this situation.

a. Measures regarding ongoing loans:

- Weekly analysis of outstanding loans and interest with recovery actions;
- Intensification of credit recovery activities, paying special attention to debtors with significant exposure and those with due dates after the 25th of the month;

- Telephone contact with debtors who have recorded a debt service delay of at least 15 days;
- Notification of debtors and guarantors with overdue debts for the purpose of prompt recovery;
- If notifications are not effective, proceed to send payment notices to the debtors' employers and guarantors.

b. Measures regarding loans and interest undergoing forced execution:

- Regular monitoring and analysis of loans and interest in the process of forced execution;
- Collaboration with the legal executor to ensure a smooth and effective execution process;
- Exploration of options for restructuring or settlement for debtors undergoing forced execution, considering individual financial situations;
- Timely communication with debtors involved in forced execution to explore possibilities for resolution and negotiation;
- Continuous evaluation of the effectiveness of measures taken and adjustment of strategies as needed to enhance the recovery process.

c. Measures proposed for preventing or limiting the growth of overdue receivables:

- Thorough analysis of credit files with increased attention to compliance with lending standards, considering the economic and social crisis.
- Strict adherence to counterparty risk regarding the acceptance of guarantors.
- Requesting additional guarantors when necessary without burdening or complicating the debtor's situation.

- Special focus on guarantors who are pensioners, considering that the Pension House in Braşov County makes deductions without forced execution.
- Demonstrating high standards in lending activities by selecting customers with good creditworthiness and a payment capacity that ensures timely repayment of obligations.
- Increasing prudence in lending activities by obtaining necessary information about the applicant's financial and family situation, verified income, and owned assets, including the number of family members, etc.
- Using mortgage as a form of collateral for large loans.
- Ensuring mortgaged properties in favor of the cooperative bank with the transfer of claims in favor of the bank to an insurance company.
- Checking the database of debtors listed in the Credit Risk Central Registry to eliminate credit risk for customers with uncertainties regarding assumed commitments.

Continuing, we want to analyze the liquidity risk management strategy of Unirea Brasov Cooperative Bank. This strategy must continuously monitor the liquidity level to ensure a constant state of liquidity. Liquidity expresses the ability of assets to be quickly and with minimal costs transformed into liquid currency (cash or available in the current account). Liquidity is a liability and asset management issue that involves different degrees of transformation into liquid currency. The qualitative assessment of liquidity involves evaluating the risk based on compliance with the limits established according to the chosen risk level by the cooperative bank (Constantinescu, C.E., 2022)

According to the short-term liquidity risk management strategy and policy, the risk will be covered by the liquidity reserve, which is part of the balancing capacity and represents the available liquidity covering additional liquidity needs that may arise over a short time horizon defined in crisis conditions. The management of medium and long-term liquidity will be achieved through the provision of loans with maturities better correlated with the real maturity of sources and the diversification of lending products.

The cooperative bank has anticipated that ensuring the necessary liquidity in medium and long-term crisis situations can be obtained from external sources (when it is not possible to secure liquidity internally) by resorting to the form of credit granted by the Cooperative Central Bank CREDITCOOP and cooperative banks within the CREDITCOOP network, with which alternative financing agreements have been concluded for this purpose:

- Financing Agreement no. 1.711/29.12.2021 concluded with Eurocoop Cooperative Bank Sfântu Gheorghe, amounting to 500,000 lei;
- Financing Agreement no. 464/29.03.2019 concluded with Economcoop Cooperative Bank Bacău, amounting to 800,000 lei.

As of December 31, 2021, the liquidity risk at Unirea Brasov Cooperative Bank was at a low level. In case of an increase in liquidity risk, the bank can undertake the following measures:

a. Tempering/Suppression of Lending and Investment Activities for a Certain Period:

- To temporarily reduce or suspend lending and investment activities.

b. Attracting New Term Deposits in Areas with Lesser Economic Crisis Impact:

- To attract new term deposits in regions where the economic crisis has a lesser impact. Bank employees may be incentivized to attract these funds by providing benefits, which could represent up to 1% of the amounts attracted, depending on the deposit period.

c. Attracting New Cooperative Members:

- To attract new cooperative members, leading to an increase in social capital and, consequently, an increase in internal funding sources.

1. To monitor and maintain liquidity risk at a low level, Unirea Brasov Cooperative Bank, through the Treasury, Operations,

and Clearing service, can employ the following strategies and actions:

2. To Continue monitorising of immediate liquidity levels to identify periods where liquidity deficits may occur in advance.
3. To Continue tracking of upcoming payments (e.g., customer orders, loans, salaries, salary contributions, etc.) in the near future.
4. Using banking tools (commissions, interest) to maintain customer account balances and deposits.
5. To Identificate the customer needs and modification/ launching of new savings products.
6. Cash redistribution from branches with excess cash to those experiencing deficits.
7. Cash withdrawals from the CREDITCOOP central bank.
8. To increase the communication with the bank's important customers who have loans or deposits.
9. Employee motivation through bonuses based on the funds attracted by them.
10. Collaboration with advertising providers to promote savings product offerings.
11. Acceleration of utility bill collections through various promotions and the expansion of operations conducted on mandate to increase liquidity.

Conclusion

In conclusion, credit institutions must adopt policies for managing significant risks to implement the chosen risk profile. These respective policies should align with overall strategies, be correlated with the level of the institution's equity, reflect their experience in risk management, and adhere to the risk exposure determined by the board of directors.

Policies regarding the management of significant risks, appropriate to the nature, size, and complexity of the activities of credit institutions, should be clearly and transparently translated into internal norms, procedures, including manuals, and codes of conduct. These policies for managing significant risks should ensure, as applicable, the following:

- Establishment of at least a system of procedures for authorizing operations affected by these risks;
- Design of a system for setting risk exposure limits and monitoring them, reflecting the chosen risk profile and in compliance with current legislation and regulations;
- Correlation of limits set at the level of activities and/or secondary branches/offices with those set at the overall level of credit institutions;
- Establishment of a reporting system for risk exposures and other risk-related aspects to the relevant management levels;
- Establishment of a system of procedures for unforeseen situations;
- Establishment of criteria for recruiting and remunerating staff, setting high standards for their training, experience, and integrity.

Regarding liquidity risk management, the current financial crisis serves as a true stress test for credit institutions. By implementing appropriate measures to improve the liquidity crisis situation, necessary results are achieved with high efficiency. Considering the deficiencies in Basel III highlighted by the financial crisis, experts are making proposals for the implementation of Basel IV.

In Romania, the implementation of Basel III began in January 2014, and the application of the Directive IV on capital requirements (Capital Requirements Directive CRD IV) includes the main improvements to the regulatory framework. These improvements pertain to:

a) Quality and level of regulated capital;

b) Leverage ratio indicator;

c) Liquidity requirements;

d) Use of external ratings;

e) Corporate governance and remuneration requirements;

f) Macroprudential requirements and national flexibilities.

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