

# STRATEGIC MANAGEMENT IN COMMERCIAL BANKS

Stelian PÂNZARU\*

**Abstract:** *The current state of development of financial markets and financial system, and environmental developments in which they operate have imposed a different perspective approach to economic risk issues generally and the banking in particular. Until the 1970s the banking risks took into consideration just the credit risks in the bank's relationships with customers and the payment system; as instability has already become a dominant feature of the economic environment, banks face new risks.*

*To meet the new challenges one must identify risks and determine their causes and their influence, developing procedures, techniques and tools for measuring, mitigating and avoiding them, knowing that banking risks are a source of unexpected expenses .*

**Keywords:** credit risk, banking globalization, multinational banks, European banking system, banking concentration.

**JEL Classification:** M<sub>10</sub>, G<sub>21</sub>, G<sub>24</sub>.

## 1. Requirements and Options

The competitiveness of the banks today has its origin in the strategies they adopt and apply, strategies in which risk management plays a key role. The conditioning of the banking performance on the content of banking management in general, and especially on that of financial-foreign exchange risk management, evident for almost all banks, explains the interest of researchers and practitioners to this area. Its location in the forefront of modern banking management applies to the whole banking system,

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\* "Spiru Haret" University, Romania, Faculty of Management, Braşov, panzarus@gmail.com.

including central banks, which must be able to have strategies to identify, commensurate and minimize global banking risks.

In defining banking risk, most experts just look at the treatment of credit or liquidity risk, arising from the classical function of banks. Others focus on the identification of potential or actual loss caused by random risks such as fraud, natural disasters. Thus, sequential approaching to banking risks is not surprising, since banking risk issues and their management did not have the importance it has today, both for practitioners and for scholars. Global banking risks should be viewed, analyzed from a systemic perspective, emphasizing the interrelationship between them, knowing that one can generate the chain production of other risks. Whatever type of banking institutions - regional, local, universal, investment and retail banks - all have adjusted their behaviour as actors on the financial-banking market in the light of developments in the banking system marked by globalization, increasing competition, financial market liberalization, emergence of financial innovations (Constantinescu, L., Ștefănescu, C., 2010, p. 112).

Traditional banking practices, focusing on the formation of deposits and credit, is now only part of the activities of banks, new market orientation and diversification bank putting his mark on risk management to avoid any gaps in business banks. Thus, the analysis places the traditional banking instruments such as quantitative indicators (used to assess bank loan portfolio quality indicators of liquidity, capital adequacy or open positions by currency risk) in the centre assessment and risk management. Although this type of static analysis is extremely useful, it is not an appropriate indicator of a bank's risk profile.

A relatively new concept in the literature and in the banking practice is a risk-based analysis of banks, which requires constant analytical review of bank activity, ensuring stability and confidence in the financial system. This approach involves extending the analysis tools that traditional banking operate with, which are points of departure for the anticipation of risk and performance simulation, changing them while providing a dynamic picture of bank performance. Moreover, financial indicators (i.e. balance sheet structure, profitability, market risk and credit risk, liquidity and foreign currency positions) are subject to banking supervision, each bank having the obligation to calculate report and monitor their levels. Risk-based analysis takes into consideration other factors such as quality and style of management, consistency and effectiveness of policies and banking

procedures, efficiency and completeness and accuracy of monitoring risk and opportunity management information systems.

The objective of risk management lies in minimizing the risks facing the bank, so it is possible to maximize the value of the bank. Some economists consider that bank risk management is part of financial management, with planning and financial forecasting, accounting systems, internal controls and cash. This approach appears to be made from a narrow perspective; in fact risk management must respond to a number of challenges.

Practitioners believe that an appropriate risk management ensures the bank the ability to identify, quantify and monitor the risk profile and to avoid them and finance them. These items are actually found in each type of risk management, but they acquire a new dimension at a global level. The success of risk management depends on the bank's ability to anticipate potential losses, reserves policy, transfer losses, and the degree of its integration into the bank's overall management system:

➤ Identification of banking risks depend on the diversification of business lines or the range of banking products offered to customers and involves the development of risk profile. In determining the risk profile should keep in mind that many risks are interrelated, a particular exposure can cause risks of several types.

➤ Quantifying risk involves the use of techniques, tools and skills necessary for the bank to commensurate risks. Development of quantitative modelling tools allow simulations that are useful in analyzing the effects induced by changes taking place in the banking environment over the bank's risk profile and its impact on the bank's profitability and net worth.

Basel agreement on capital adequacy attaches importance to the quantitative modelling tools and the ability of banks to use them, creating prerequisites for the implementation of rating-based approach for assessing internal capital adequacy of banks. Approach based on internal ratings determine the continuing improvement of internal risk management practices in general and credit risk, market and operational in particular.

➤ The purpose of monitoring is to minimize the risks associated costs related to all risk exposures were identified and quantified. For example, to monitor market risk management techniques may be customary balance sheet (assets and liabilities management) or to diversify the portfolio and the liquidity risk tenure. Meanwhile, risk monitoring should be part of the

prudential limits imposed by the monetary authority. Special monitoring of risk exposure of a bank is justified when it is anticipated the occurrence of events with negative impact on the bank. Tools, techniques or procedures used to quantify and monitor risks are not universal and standardized practice by showing that they are specific to each bank, but it also does not replace the prudential norms and aims at enhancing risk-torque performance.

Risk management is an integral part of the bank's strategy, addressing this vulnerability and complexity of the environment in which the bank operates. It is accepted that the risk profile is an essential component of the bank and therefore further development of banking strategy will be achieved if current and future risk profile are neglected.

➤ Evaluation of risk management policy is to measure the performance obtained after exposure coverage and enables optimization of future policies based on identified weaknesses and countries.

The literature deals with risk management in terms of developed financial and banking markets, capable of providing the necessary valves to restore a state of balance in the event of adverse effects that may generate risks. The characteristics of the Romanian economy require both adaptation practices and world concepts and application of methods specific to the internal financial and banking system.

## ***2. Credit risk in the current credit market development***

Credit risk is defined by the losses incurred by a trader because not collection due to anticipated income stream as a result of deteriorating credit quality of the borrower. From this perspective, credit risk has two coordinates: the size of risk and quality.

Risk dimension indicates the size of the loss suffered by creditors as a result of the inability of the debtor to repay the loan, and the quality of the resulting risk of the possibility that non-payment to take place and the safeguards that may reduce the loss, failing payment. Non-payment of debt represents an uncertain event.

In addition, future exposures are not known with certainty only at maturity, as based lending programs established reimbursement contract-based farms are applicable only in a few cases. Early repayment of loans credit risk, as in this case the bank must ensure replenishment profit and income to cover expenses incurred in granting that loan.

Based on these considerations, credit risk can be divided into three risks: default risk, risk exposure and risk recovery.

➤ **Default risk** - the risk is the likelihood of non-payment of debt maturity. There are several possible definitions that we can give default: do a payment obligation, breach of an agreement or non economic. Failure of payment is declared when the scheduled payment was not made in a minimum period from the due date. Economic Failure occurs when the economic value of the debtor's assets falls below the outstanding liabilities, which may not pay back debt.

Deterioration of some economic and financial indicators in relation to the contraction of credit made to date may be considered a technical non-payment. Usually, the default triggers negotiations, even if non-return loans at maturity do not compromise the debtor's creditworthiness. In some cases the bank may use even prompt refund request that all outstanding debts.

Not collection definition is important in estimating the chances not collection. Rating agency believes that non-payment happens when a payment under the contract has been paid over a period of at least three months. The various cases of default do not give rise to immediate loss, but certainly increase the likelihood of a final non-payment. Thus, default risk expresses the likelihood that non-payment to take place during a given period of time and depends mainly on the situation of the debtor: company size, quality of management, operation, development of economic and financial indicators (Ștefănescu, C., Popa, L., 2009, p.168).

Default probability can not be measured directly, but one can use historical domestic default statistics, rating agencies or the central authorities.

The most representative types of ratings are: the rating of debt issued, the issuer rating and the rating industry.

In most cases, risk rating agencies assess the quality of debt, which is double conditioned: by the probability of default and by the recovery possible in case of default. Internal bank ratings can often include other dimensions than the risk of default and recovery and can be used to assess each customer individually.

➤ **The risk of exposure** - the risk of exposure quantifies uncertainty on the collection of amounts borrowed. If the loan is repaid under a firm contract program, the risk of exposure can be considered low or negligible. Unfortunately, this is not true for all lines of credit. If committed

credit lines allow the debtor to access these lines whenever desired, according to his needs and a maximum limit set by the bank so the bank's risk exposure in this situation is considerable.

➤ **The risk of recovery** - If default, recoveries are not expected. They depend on the type of default and other factors such as the debtor's collateral, the type of collateral that may be collateral or a third party. A non-payment of the payment does not mean that the debtor will never pay, but draws the initiation of certain actions such as renegotiation or repayment obligation outstanding. If no corrective action is not taken into account when intervening legal proceedings: legal investigation of the collateral (which differs depending on the type of collateral accepted), performance guarantees (Greuning. H., Brajovic, B., 2004, p.58).

From a quantitative point of view, credit risk is measured by bank losses if default. Credit risk results from a combination of default risk, risk exposure and risk recovery. Resulting loss (L) is random and can be regarded as the product of a random variable characterizing the default (D), an uncertain exposure (X) and an uncertain recovery rate (R).

$L = D \times X \times (1 - R)$  this expression quantifies credit risk.

The risk of default or LGD depends on the values assigned to the three basic parameters:

- probability of default;
- exposure;
- recoveries.

Expected loss is the result of loss caused by default and the probability of default. LGD is the amount at risk, or exposure, less recoveries:

$LGD = \text{exposure} - \text{exposure recovery} = x (1 - \text{recovery rate } \%)$

The expected loss represents both the loss caused by default and the quality of risk:

$\text{Expected loss} = LGD \times \text{probability of default} = \text{exposure} \times (1 - \text{recovery rate } \%) \times \text{likelihood of default } (\%)$ .

In other words, the expected loss includes in a measure all the three components of risk: **exposure, probability of default and recovery.**

Basel Committee proposes to address the credit risk from the prospects of internal models (Internal Ratings Based Approach - IRB). Advantages of using these internal models (1) are:

- relevant assessment of the borrower and transaction characteristics and risks relevant differentiation and a quantitative estimate of their fair and consistent;

- importance in risk management, decision making, credit approval, the allocation of capital and establishment of internal control functions;
- control of credit risk without subjective influences.

In this regard, the Basel II brings new elements to the Basel I risk weights range expansion, diversification of instruments to mitigate credit risk by using derivative financial instruments (credit default swaps, total return swaps, credit linked notes), use ratings for assessing clients and developed internal models for determining the amount of expected loss, given the risk profile.

To assess credit risk, Basel II proposes two alternatives:

- Using standard standardized approach, whereby credit risk is calculated by the central bank for each type of asset based on fixed risk weights established in relation to the typology of credit, use of internal models with two variants of the basic and advanced internal models, which allowed for the bank to assess risk according to the specific placement of each part. The capital requirements are calculated according to four risk parameters: probability of default (PD), loss in the event of default (LGD), exposure to debtor (EAD) and maturity exposure (M). Expected Loss (EL) is determined according to the relationship:  $EL = PD \times LGD \times EAD$ , capital requirements are equal to the difference between the value of the bank's risk exposure and expected loss;
- the internal models based approach, banks determine the PD and the supervisor sets the other three risk parameters;
- the advanced approach, banks calculate all the parameters required to establish capital requirements, economic capital and the difference between the regulated minimum.

Basel Committee has developed five quantitative impact studies on the effects of Basel II on risk management. The last survey conducted in June 2006 aimed to assess the credit risk and operational in terms of two coordinates:

- models applied in both risk management;
- percentage change in capital requirements induced by the models used by each credit institution.

### **3. Conclusions**

The results of our study highlight the fact that the banks from advanced countries prefer advanced domestic models, regardless of their size, especially since this alternative incite to modelling the credit risk, being common practice among strong banks. On the other hand, the banks from the emerging countries prefer the standardized method. If we consider the massive involvement of the banks with foreign capital in these markets, and their preference for internal models, the full implementation of the Basell II Agreement could be accelerated by their pressure.

The implementation of the Basell II Agreement in the Romanian banking system should develop means for achieving the banking supervision through the transposition into the Romanian legislation of the directives and adapting the prudential reporting system, developing guidelines for internal model validation and their validation. Also, the banks will have to use other products in order to minimize credit risk.

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