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APPLIED ISSUES ABOUT BANKING RISK MANAGEMENT

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Abstract

The following paper emphasizes the need to deepen the understanding of the notion of banking risk management by explaining the significant risks the bank encounters during financial exercises, as well as their additional entries. The study from the paper will focus on UniCredit Bank during the years 2014 and 2015 on all types of risks, in which we will provide comprehensive data on how UniCredit Bank management applies its risk policies.

Keywords: *bank risk management; UniCredit Bank; significant risks; market risk; credit risk.*

JEL Classification: G_{30}, G_{32}

Introduction

The changing environment in which banks operate, generating new business opportunities also means that risks are more complex and diverse, are challenging traditional approaches to bank management, thus forcing the banks to manage them appropriately in order to survive competition and to maximize profit and market position.

In accordance with the regulations of the new Basel Accord, known as Basel supervisory authority in Romania, banking companies must implement new policies and methods designed to help increase the pace in identifying and managing significant risks of banking activity, namely credit risk, liquidity risk, operational risk, reputational risk and the risks attached to them. To have an effective internal control system, the bank must identify and constantly evaluate the faced significant risks, which may endanger the internal control objectives.

Significant risks are identified based on the impact they have on the situation of banks. Identification and evaluation of significant risks must be done considering both internal factors (complexity of the organizational structure, activities' nature, staff's quality and its fluctuation, etc.) and external factors (economic conditions, changes in the banking system, technological advances, etc.).

Significant risks and additional entries may be grouped as follows:

1) *credit risk*, additional credit risks: transfer risk and country risk;
2) *market risk*, additional risks: prices risk, currency risk and interest rate risk;
3) *operational risk*, additional risk: legal risk;
4) *reputational risk*.

When given, the bank must consider the risks associated with derivatives transactions. In the process of risk management, the bank should employ a risk management committee. The bank also must choose a risk profile, establishing the objective and strategy for each significant risk, including with regard to outsourced activities, and should adopt appropriate policies for managing significant risks in order to achieve the risk profile chosen.

For a better understanding of the above, we illustrate the following risk management policy adopted and implemented by UniCredit Bank.

The Risk Management Policy of UniCredit Bank

UniCredit Bank was adequately represented at management level in various associations and international forums in Romania and at the UniCredit Group. Policy risk management in UniCredit Bank is as follows:

1. ***Market risk:*** is the risk of loss or failure to achieve estimated profits arising from fluctuations in market prices, interest rate and exchange rate. [van Greuning & Brajovic-Bratanovic, 2009]

a. *Currency risk*: is a component of market risk arising from the fluctuations of the exchange rate market. [van Greuning & Brajovic-Bratanovic, 2009]

UniCredit Bank is exposed to currency risk through foreign exchange transactions made in RON and other currencies linked to mix currencies in which assets and liabilities are denominated. UniCredit Bank's major currencies with which it currently operates are the EUR and USD. UniCredit strictly monitors the currency position, the limits being set by the central bank and other internal regulations. Net foreign currency positions are fixed by the Bank and prudentials are lower than the limits imposed by the NBR. The limits are expressed in EUR equivalent.

The open foreign currency position of the Bank in the years 2014-2015 is as follows:

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Currency	2014 Limits (equivalent mil. EUR)	2014 Usage average	2015 Limits (equivalent mil. EUR)	2015 Usage average
EUR	***40***	***21.2***	***40***	***20.7***
RON	***40***	***21.2***	***40***	***20.7***
USD	***5***	***3.3***	***5***	***7.0***

Source: IFRS individual financial statements, 31 December, 2014; IFRS individual financial statements, 31 December, 2015.

Financial assets and liabilities in national currency and in foreign currencies held by the bank are as follows:

	RON	USD	EUR	other
2014				
Financial assets *(share in total assets)*	***44.4%***	***2.1%***	***53.3%***	***0.2%***
Financial liabilities *(share in total liabilities)*	***45.9%***	***3.8%***	***50.1%***	***0.2%***
2015				
Financial assets *(share in total assets)*	***48.6%***	***5.8%***	***45.4%***	***0.4%***
Financial liabilities *(share in total liabilities)*	***45.9%***	***5.2%***	***48.2%***	***0.7%***

Source: IFRS individual financial statements, 31 December, 2014; IFRS individual financial statements, 31 December, 2015.

b. *Interest rate risk or interest rate*: is a component of the market risk that arises from fluctuations in market interest rates. [van Greuning & Brajovic-Bratanovic, 2009]

UniCredit Bank faces interest rate risk due to exposure to adverse changes in market interest. Moreover, the changing market interest rates directly affects revenues and expenses related to assets and financial liabilities, bearing floating interest rates and the real value of the interest-bearing assets. For financial receivables and liabilities in RON, the bank aims to correlate current interest rates in the market and a positive yield interest.

For financial assets and liabilities in currencies other than RON, the bank aims to maintain a net positive position. To this end, most of the assets and liabilities in foreign currency bear interest at floating rates, which can be exchanged at the bank's initiative or relating to variable interest rates on the interbank market reference.

Interest rates related to currency and significant foreign currencies during 31 December 2014 and December 31, 2015 are as follows:

Currency	***Interest Rate***	***2014***	***2015***
RON	***Robor at 3 months***	***1.70%***	***1.02%***
	Robor at 6 months	***2.01%***	***1.34%***
EUR	***Euribor at 3 months***	***0.08%***	***-0.13%***
	Euribor at 6 months	***0.17%***	***-0.04%***
USD	***Libor at 3 months***	***0.26%***	***0.61%***
	Libor at 6 months	***0.36%***	***0.85%***

Source: IFRS individual financial statements, 31 December, 2014; IFRS individual financial statements, 31 December, 2015.

2. ***Credit risk:*** is the risk of loss or failure to achieve estimated profits due to the failure of a counterparty to contract obligations. UniCredit Bank is exposed to credit risk, i.e. the risk of negative impact on earnings, due to the failure of the bank's debtor's obligations under the terms of credit agreements in the short, medium and long term. [van Greuning & Brajovic-Bratanovic, 2009]

The bank manages this risk both at the transaction and the borrower level, as well as globally through a comprehensive set of measures:

- a careful assessment of the creditworthiness of customers and risk exposure related to credit applications;
- continuous monitoring of exposures to identify any changes that may adversely affect exposures or may result in breach of risk limits established by internal procedures;
- general risk provisioning, coupled with the expected loss and the allocation of risk provisions for exposures with high risk or are in default;

• allocation of capital for unexpected potential losses from credit risk, in accordance with the regulatory framework and policies of UniCredit Group;

• continuous monitoring of the credit risk profile of the bank, in order to control and enforce its limits defined in accordance with risk management strategy and the risk appetite of the bank.

Also, in terms of ensuring prudent management of counterparty credit risk, UniCredit Bank collaborates with international correspondent banks with appropriate risk policy ratings and evaluation criteria, as well as following strict internal rules. To this end, the bank sets specific limits for deposits and transactions on foreign exchange transactions with other banks.

Bank's loan portfolio for the years 2014-2015 has the following structure:

	2014	***2015***
– ***performing loans***	***73.6%***	*89.4%*
– ***loans past due but not impaired individual***	***5.8%***	*1.5%*
– ***individually impaired loans***	***20.8%***	*9.1%*

Source: IFRS individual financial statements, 31 December, 2014; IFRS individual financial statements, 31 December, 2015.

3. ***Liquidity risk:*** is the risk of loss or failure to achieve estimated profits, resulting from the inability of the banks to honour their payment obligations at due time, resulting in costs or losses the banks may incur. As a financial institution, UniCredit Bank is exposed to liquidity risk (the risk of not having the ability to meet payment obligations at maturity). [van Greuning & Brajovic-Bratanovic, 2009]

Among the main causes leading to the risk of liquidity, the bank distinguishes:

• the lack of synchronization of time or value of the incoming/outgoing streams of cash (liquidity mismatch risk). This risk depends on the bank's balance sheet structure by maturity;

• occurrence of unforeseen events related to customer behaviour (contingency liquidity risk). This risk is manifested in particular by massive withdrawals of deposits in a short time;

• dysfunctions in the financial markets, especially money market (market liquidity risk). This may arise as a result of events where the vast majority of market participants did not expect, or due to the lack of development and maturation of the market.

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By its nature, the liquidity risk is a high potential systemic risk of contagion to the whole banking system. Therefore, in order to limit potential damage caused by liquidity problems, UniCredit Bank continually evaluates macroeconomic conditions, with emphasis on data relating to banking.

The bank's strategy on liquidity management to maintain a balance between the inflows and outflows of funds in terms of volume and maturity is vital to ensure operational continuity of a normal banking activity and adequate reserves of liquidity, ensuring balance sheet and financial stability, while optimizing funding sources and costs. Therefore, UniCredit Bank addresses distinctly short-term liquid-dity management and medium and long term liquidity management (structural liquidity).

UniCredit uses a reporting system daily, weekly and monthly to monitor the position of total liquidity and currency, and regular stress testing is made in terms of liquidity, by simulating scenarios with different degrees of severity. These simulations are performed based on the concept of "operating liquidity (maturity) ladder". The effects of plausible events on inflows and outflows of cash are considered for periods of time under defined events.

Regarding structural liquidity management, UniCredit Bank aims to ensure the financial stability of the balance sheet. The main objective is, on the one hand, to avoid excessive pressures and uncertainties in respect of the funding requirements for short-term liquidity position, and on the other hand, to optimize sources of funding and costs. This can be achieved by maintaining a proper balance between the medium and long term assets and sources of funding.

Among the financial indicators highlighting the liquidity position of the bank in the years 2014-2015, we mention:

	2014	*2015*
– **provisions (mil. €)**	**211.5**	***68.0***
– **coverage of the loan portfolio with provisions**	**10.2%**	***8.8%***
– **coverage cash rate deposits**	**63.4%**	***60.5%***
– **loans with maturity under one year**	**56.1%**	***55.5%***
– **the ratio of liquid assets and deposits**	**42.6%**	***35.1%***

Source: IFRS individual financial statements, 31 December, 2014; IFRS individual financial statements, 31 December, 2015.

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4. ***Management of cash flows:*** UniCredit focuses on risk monitoring cash flows in the normal course of business and for longer periods of time. The main categories of activities, monitored to cover the risk arising from fluctuations in cash flows are operating activities, financing and investment. [van Greuning & Brajovic-Bratanovic, 2009]

Financial indicators reflecting cash flow risk management of the bank in the years 2014-2015 were:

	2014	***2015***
– hedging reserve of cash flows (mil. €)	***-62.8***	***-46.6***

Source: IFRS individual financial statements, 31 December, 2014; IFRS individual financial statements, 31 December, 2015.

5. ***Derivatives:*** 31 December 2015, UniCredit Bank is implementing the following types of contracts: currency swap contracts; forward contracts; interest rate swaps; cross swaps (cross currency – with different currencies), foreign exchange options and interest rate options. Foreign exchange options and interest rate swaps and interest rate swaps entered into with customers are closed “back-to-back” with another entity within the UniCredit Group. Note that derivatives are traded in the OTC market.

The value of derivatives (notional value) from late 2014 to 2015 is as follows:

	2014	***2015***
– value derivatives exchange (ROL bn.)	***3.1***	***3.6***
– value of interest rate derivatives (ROL bn.)	***3.8***	***4.4***

Source: IFRS individual financial statements, 31 December, 2014; IFRS individual financial statements, 31 December, 2015.

6. ***Tax risk:*** UniCredit Bank ensures sustainable progress on taxation risk management by building and maintaining transparent fiscal functions, operational and effective within the organization. The bank strictly observes and applies tax legislation for all categories of taxes.

7. ***Compliance risk:*** In a complex legal framework, the bank is subject to compliance risk defined as the risk of current or future impairment of profits and capital, which can lead to fines, damages and/or termination of contracts or may affect reputation of the credit institution as a result of violations or non-compliance. [van Greuning & Brajovic-Bratanovic, 2009]

Therefore, in order to meet legal requirements of the compliance risk, UniCredit Bank Directorate assists in the management of compliance risk. Also, the Directorate contributes to the identification, assessment, monitoring and reporting of compliance risk associated activities, including the advising on compliance work undertaken with the legal provisions and internal regulations of UniCredit Group.

8. ***Operational risk:*** is the risk of loss or of reaching the estimated profits, which is determined by domestic factors (conducting improper activities, domestic existence of inadequate personnel or systems) or external factors (economic conditions, changes in the banking environment, technological advances). [van Greuning & Brajovic-Bratanovic, 2009]

UniCredit Group defines operational risk as the risk of losses resulting from external errors, and violation events. Some of the causes of operational risk are the following events: inadequate or failed internal processes, errors, personnel or systems, to external events or systemic fraud, external employment practices and workplace safety, customers complaints, product distribution, fines and penalties due to rule breaking, physical property damage, business interruption and failures of the administration processes.

Exposure to operational risk analysis considers the following factors: *operational risk losses, insurance recoveries and operational risk indicators; trends resulting from the analysis of scenarios; relevant internal and external events; capital requirements for operational risk and operational risk mitigation measures, including risk transfer through insurance.*

The mandatory information to calculate capital requirements is losses, provisions, release of funds and recoveries; other costs are only relevant for the control and mitigation of operational risk exposure. The specific indicators of operational risk are the data reflecting operational risk profile: value of the indicator should be correlated with changes in the level of risk. Operational risk monitoring indicators signalling system is a preventive operational risk for those who manage risk in their daily activities and the persons directly responsible for risk management. Setup, updating and management of operational risk indicators are the responsibility of risk managers and those responsible for risk reporting within processes.

Identification and collection of operational risk losses is based on the following categories of events:

- Internal fraud – losses arising from acts such as those committed with the intent to defraud, misappropriate property (legally) or violation/circumvention of regulations, legislation or company policy (excluding events such as discrimination or violation of the principles of diversity), involving at least one person from within, but excluding intentional damage to property. Internal fraud originated within society and the internal nature of the event should be determined unequivocally, otherwise the event will be considered external fraud.

- Outsourced fraud losses arising from acts such as those committed with the intent to defraud, misappropriate property or violation/circumvention of the law, by a third party without the help of an employee and excluding damage to property.
- Employment practices and safety at work – losses arise from acts contrary to law and conventions on employment, health and safety at work, the payment of damages for personal injury or practices/discrimination events or violation of the principles of diversity.
- Clients, products and business practices – losses from unintentional or negligent breach of professional obligations to clients (including fiduciary/safety and adequacy of services) or from the nature or design of a product. In this category fall both the events in which the company is responsible for the breach, and when the company has been the victim of similar practices by other company.
- Losses on tangible assets – losses arising from loss or damage to physical assets, from natural disaster or other events.
- Business disruption and system failures – business interruption losses or system failures.
- Execution, delivery and management processes – production losses due to failed transaction or inadequate management processes.

The types of losses that may arise from the events of operational risk are:

- payments to customers and employees determined by the courts after disputes triggered by them;
- payment of fines, penalties, etc.;
- payment of costs and expenses;
- damage to the reputation of the company through involvement in various lawsuits and disputes, and their coverage;
- shortcomings in management;
- material and financial damages arising due to the occurrence of events detrimental to the condition and value of company assets;
- payments by the company as a result of incorrect or unprocessed transactions ordered by the company’s customers.

All the departments within the Group are responsible for managing and monitoring operational risk.

9. ***Reputational risk:*** is the risk of loss or failure to achieve estimated profits due to a lack of public trust in the integrity of banks. [van Greuning & Brajovic-Bratanovic, 2009] Identification and evaluation of reputational risk in the bank is at the level of the whole company and all its organizational levels and account for all company activities, the outsourced activities and the emergence of new activities.

In terms of potential reputational risk, attention should be paid to the following:

- achieving or exceeding the limits established for the significant risks;
- achieving or exceeding the limits to financial indicators (liquidity, solvency, etc.);
- email – potentially at risk from transmission by mistake or intentionally, of confidential/wrong information within the company, to the outside by e-mail with identifying data from the company;
- external communication by unauthorized personnel – potential risk by submitting truncated data confidentiality;
- staff fluctuations – pressure in terms of confidentiality of information and risk, in terms of company processes and procedures regarding the properties, in particular the rules on internal and external communication;
- negative media campaign – by presenting unilateral potential risk of some aspects of the company's activity;
- focusing on specific sites of opinions exclusively from dissatisfied customers, substantiated or not, aspects noticed and known to divisions/ departments responsible for the company's employees.

Reputational risk monitoring is achieved by:

- daily monitoring of all publications in connection with UniCredit Consumer Financing;
- daily evaluation of items that could pose a potential reputational risk for UniCredit;
- consumer Financing strategy for each case, established together with communication management;
- IT system monitoring and the establishment of clear and restrictive rules and procedures on how to use e-mail in customer and external communication.

The general strategy of the company reputation risk management is carried out, without limitation, by:

- proper implementation of CDD own rules and regulations regarding the prevention and combating money laundering;

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- selection through rigorous analysis of the customers that apply for loans; developing policies/plans/security measures for certain activities/services of the company;
- measures required for the proper management and mitigation of the negative consequences of extending the internal structure that appears as a reputational risk event/item generator;
- developing a suitable form of presentation/communication of information materials and the promotion of business and company products;
- establish work procedures and decision-making powers in the event of a crisis;
- other reputational risk management measures that the company's management deems necessary;
- appropriate, qualitative or quantitative reputational risk assessment (such as: losses caused by negative publicity that can be quantified, litigation etc.).

Permanently, the company will try to limit reputational risk procedures, rules and streams especially created for this purpose and supported by proactive communication, transparent and efficient.

All the departments in and of the bank are responsible for the reputational risk management and monitoring.

Conclusions

To conclude, in spite of the current market and economic challenging environment, UniCredit Bank has recorded a good performance in 2015 giving it a solid financial position and proving the potential to have a continued growth capacity.

As future objectives, UniCredit Bank should consider developing higher quality services by providing a larger range of products and services to individuals, as well as legal persons. Also, the bank should focus more on value-added services, risk management, profitability, productivity and strengthening its market share.

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